Defending a Cash Business Taxpayer in an Indirect Method Case

By Eric Smith

Taxpayers involved in cash businesses are frequently under the incorrect impression that they are audit-proof and free from risk of criminal liability when the income and deductions reflected on their tax returns match their business's books and records. While cash businesses by their nature make demonstrating understatements of income or overstatements of expenses generally more difficult, the government has developed numerous indirect methods to overcome these issues in either an audit or prosecution of cash business taxpayers. Because these indirect methods focus on recreating the taxpayer's income over one or multiple tax years, a professional defending such a taxpayer will usually need to painstakingly examine all of the taxpayer's assets, liabilities, and expenditures during that period. This article will describe the most common types of indirect methods used by the government and the most frequent defenses used in defending such taxpayers.

What Is an Indirect Method?

The IRS or a criminal prosecutor may use either a direct method or an indirect method to show unreported income or improper deductions. In a direct method case, the government will use direct evidence (e.g., the testimony of witnesses with firsthand knowledge or documentary evidence) to demonstrate that the taxpayer's return is inaccurate. The direct method is commonly called the "specific items" method, because the government seeks to demonstrate that a specific item either appearing or failing to appear on the return is erroneous. Therefore, in a criminal direct method case involving omitted income, the government will frequently call the taxpayer's accountant as a witness to testify that the prepared returns did not include the omitted income and will provide documentary evidence demonstrating that the omitted income was attributable to the taxpayer. For example, if the alleged unreported income was interest earned in a foreign bank account, the government would have a strong case of tax evasion if it can elicit testimony that the taxpayer never disclosed the existence of the account when the accountant was preparing the returns and can produce bank account statements showing that the taxpayer was the beneficial owner of the foreign account. The direct method is the government's preferred approach, because it is simplest, most accurate, and, according to the Internal Revenue Manual (IRM), hardest to rebut.

By contrast, in an indirect method case, the government does not have direct evidence to establish an inaccuracy on the taxpayer's return and thus must use other means to demonstrate the error. These methods are usually used by the government against taxpayers involved in cash businesses where either no records of their receipts have been kept, or the receipts do not match the income and expenses the government alleges were attributable to the taxpayer. The evidence in an indirect method case will most often consist of bank account statements and asset statements that can be used to demonstrate that the taxpayer's economic situation changed during the period in a manner attributable to unreported income or overstated deductions.

Types of Indirect Methods

The three most common types of indirect methods of proof used to prove a deficiency are—

- the net worth method,
- the bank deposits method, and
- the expenditures method.

The net worth method was the first indirect method to receive judicial approval, most prominently in the 1954 Supreme Court decision *Holland v. United States* (348 U.S. 121). As the name suggests, this method attempts to reconstruct income by measuring the increase in the taxpayer's net worth during the taxable year or years by creating opening and closing net worth statements. Assets are listed on these opening and closing statements at their tax basis (as opposed to fair market value) so as to avoid including unrealized appreciation. Any increase in the taxpayer's net worth is then reduced by all nontaxable income, such as loans and gifts received by the taxpayer during such period. This amount, after certain adjustments are made taking into account available exemptions, deductions, and credits, should generally approximate the taxpayer's taxable income. In either a criminal case or a civil audit in which the

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net worth method is used, the government must establish the taxpayer's starting net worth with reasonable certainty. Otherwise, any increase could be argued to have been attributable to the liquidation of assets in the taxpayer's possession at the beginning of the year.

Because the bank deposits method is much simpler than the net worth method, it has become the IRS's preferred method in civil audits. In the typical bank deposits case, the government will examine deposits made into all of the taxpayer's accounts in order to establish three essential elements: 1) unidentified bank deposits substantially in excess of reported income, 2) a starting point or opening cash balance, and 3) an ongoing business or some other taxable source capable of generating income in excess of what was reported. In civil audits, where all deposits into a taxpayer's account are assumed to be taxable income, this third element is generally excluded.

The expenditures method involves looking at the total cash expenditures made by the taxpayer during the year and subtracting the income reported on the taxpayer's return and nontaxable sources of income received by the taxpayer. As with the other two indirect methods, the government is also required to demonstrate a starting point and business or other taxable source of the income. Similar to the net worth method, an expenditures method case generally must begin with a determination of the taxpayer's opening and closing net worth in order to ensure that the expenditures were not the result of sales of property held at the beginning of the period.

Defenses for Taxpayers

One of the most common defenses taxpayers can raise against an indirect method case is to question the government's starting position (i.e., the opening net worth or opening cash balance). This "cash hoard defense" entails the taxpayer claiming that any increase in net worth or unidentified bank deposits or cash expenditures were attributable to a large amount of cash on hand that had been accumulated in prior years. The cash hoard defense is strengthened when it can be demonstrated that the taxpayer made large cash purchases during the applicable period.

Because of the frequency with which the defense is raised, a prosecutor or the IRS will generally view the claim of a large cash hoard with a great deal of skepticism, and will try to refute this claim with circumstantial evidence. Prior to raising this defense, CPAs should ensure that the claim is creditable. Specifically, the practitioner preparer needs to be able to demonstrate that the taxpayer's income from prior years was sufficient to accumulate the claimed cash hoard and, at least with respect to a net worth or expenditures case, wouldn't have been depleted by making cash purchases of property reflected on the government's opening net worth statement. This defense will also likely be rejected where the taxpayer's actions are inconsistent with having a large cash hoard. For example, making ATM withdrawals in small increments, taking out loans with high interest rates, and making periodic payments for appliances and furniture have all been cited by the Department of Justice as evidence that the taxpayer did not have a large cash hoard.

The other favored defense in an indirect method case is to claim that the source of the funds attributable to the increase in the taxpayer's net worth, bank deposits, or expenditures was a nontaxable source. In a criminal context, the government has an obligation to investigate leads furnished by the taxpayer regarding nontaxable sources that are reasonably feasible of being checked out. In a civil audit, any nontaxable sources of income not reflected in the agent's calculation will reduce the calculated tax liability.

The most common nontaxable sources claimed by taxpayers are gifts, inheritances, borrowed funds, or loan repayment. CPAs must also be on the lookout for other increases in assets arising from gains that are either nonrecognized or partially recognized under the Internal Revenue Code. These include the sale and acquisition of a residence or an installment sale, as well as an increase in receivables that is not deemed income during the period due to the taxpayer's method of accounting (e.g., cash basis).

Even where the sources are taxable, CPAs may be able to argue, in either a criminal case or in a civil audit, that the increases are attributable to sources that, although taxable, would not have been readily apparent to the taxpayers. This could demonstrate noncriminal intent or indicate that fraud was not present. For example, a nontaxable condemnation award may include taxable interest that was not separately stated and therefore easily overlooked.

Protecting Taxpayers

The IRS and state tax authorities have developed several indirect methods of proof that can be used against taxpayers with cash businesses. By their nature, these indirect methods rely on circumstantial evidence to demonstrate that the taxpayer has underreported income or overstated deductions; this makes them potentially overbroad while, at the same time, susceptible to the defenses described above. CPAs advising such professionals should keep such strategies at hand if an audit or legal action arises. ❑

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