

The IRS Audit for Cash Businesses

I. Introduction

A. “An IRS audit is an official investigation that may be the first step leading to a criminal conviction for tax violations.” United States v. Peters, 153 F.3d 445, 447 (7th Cir. 1998).

B. Types of Examinations

1. Civil Examination

- a. Field Audit is a full blown examination where a higher grade revenue agent is assigned.
- b. The larger field examinations are handled by the IRS’s Large Medium Sized Business (LMSB) division and are further divided between those that require multiple examiners operating as a team and those that require only a single examiner.
- c. Eggshell audits are civil exams that have the potential for fraud to be charged.
- d. Reverse Eggshell audits are exams that have already been referred to Criminal Investigation branch unbeknownst to the taxpayer.

2. Criminal Investigation

- a. The IRS’s Criminal Investigation branch (“CI”) conducts criminal tax investigations.
- b. The goal of CI is not to determine the taxpayer’s correct tax liability but to investigate criminal tax conduct and refer cases to

the Department of Justice Tax Division when it concludes that a taxpayer or other target of their investigation (e.g., return preparer) should be prosecuted.

C. Keeping the IRS at Bay: How Are Returns Selected for Examination?

1. Tax shelters
 - a. Returns may be selected based on information obtained by the IRS through efforts to identify promoters and participants of abusive tax avoidance transactions.
2. Computer Scoring
 - a. Computer programs give each individual income tax return a numeric score that rates the potential for change, based on past IRS experience with similar returns.
 - b. IRS personnel screen the highest scoring returns, selecting some for audit.
3. Large corporation returns are examined annually.
4. Information matching
 - a. The IRS compares thirty-party information with the information on the return and selects some returns for audit because the income reported does not match the information from the third-party.
5. Related Examination
 - a. Returns may be selected for audit when they involve issues or

transactions with other taxpayers, such as business partners or investors, whose returns were selected for examination.

6. Informants such as disgruntled employees or ex-spouses will often tip off the IRS.

D. Additional Methods for Selecting Returns

1. **Wealth Squad**

- a. New LMSB Global High Wealth Industry Group will focus on individuals with tens of millions of dollars of assets or income by looking at the entire complex web of business entities controlled by such high wealth individuals, as opposed to merely the individual's income tax return.¹
- b. Goals of Wealth Squad : Holistic approach to selecting returns based on unified look at the entire web of business entities controlled by a high-wealth individual to better assess whether the individual is using sophisticated business planning arrangements to avoid taxes (e.g., Estate and gift, trust, real estate and other investments, privately held foundations, etc.).²
- c. IRS Audit Team will consist of specialized examiners, including economists, appraisers, technical advisors, flow-through specialists and international examiners.³

2. **Voluntary Disclosures** : The IRS will mine more than 14, 700 voluntary

disclosures of offshore bank accounts for information that identifies financial institutions, advisors, and others who promoted or otherwise facilitated US person hiding assets and income offshore and attempted to shirk their tax responsibilities at home. ⁴

3. Uncertain Tax Positions

- a. Businesses with assets over \$10 million are required to disclose uncertain tax positions annually with their corporate tax return. ⁵
- b. IRS will review these positions.

4. Employment Audits

- a. IRS is conducting an Employment Tax National Research Project
 - (1) Random selection of 2,000 businesses for the next two years.
 - (2) IRS Objectives:
 - (a) To secure statistically valid information for computing the Employment Tax Gap; and
 - (b) To determine compliance characteristics so the IRS can focus on the most noncompliant employment tax areas.
 - (c) Major Issues:
 - i) Worker classification
 - ii) Fringe benefits

- iii) Expense reimbursement
- iv) Owner/ Executive Compensation

II. The Nuts and Bolts of the Examination

A. Initiation of the Examination

1. Upon initiation of the audit, the IRS will advise the taxpayer in writing of the audit and provide IRS Publication 1 regarding the process.
2. The notice letter will often also enclose an Information Document Request (“IDR”) which asks the taxpayer to produce certain identified documents.

B. Preparations for the Examination

1. “If you know the enemy and know yourself, you need not fear the results of a hundred battles.” - Sun Tzu “The Art of War”
2. Know the taxpayer, your client.
 - a. Obtain complete background information about the client.
 - b. Trust but verify the taxpayer’s information.
 - (1) Check credit reports
 - (2) Perform asset, adverse judgments, google client’s business entities and name.
 - c. Review returns.
 - d. Review bank accounts.
 - e. Review accountant’s worksheets.
 - f. Prepare Cash T - IRS Form 4822.

- g. IRM Questions about Return Preparation.
- 3. Know what the enemy knows.
 - a. Order IRS Transcripts of Account, Wage and Income transcripts, and account transcripts.
 - b. Request a taxpayer's administrative file by making a Freedom of Information Act (FOIA) request.
 - c. Request a Third-Party Contact Sheet from the IRS.
- 4. Know your enemy.
 - a. Obtain information about the Revenue Agent's track record and character.
- 5. Know the IRS Audit Techniques Guides (ATGs) for Business Audits
 - a. IRS has prepared a list of specific guides intended to develop specialized IRS examiners.
 - b. <http://www.irs.gov/businesses/small/article/0,,id=108149,00.html>
- C. Post Client Analysis: Is this an eggshell audit?
 - 1. Will the taxpayer be walking on eggshells hoping that the Revenue Agent will not determine tax fraud ?
 - 2. Agents are trained to look for evidence of fraud whenever they audit income, estate, or gift tax returns.
 - 3. The Internal Revenue Manual contains a Fraud handbook that states that "when the examiner discovers a firm indication of fraud, the examination

should be immediately suspended without disclosing to the taxpayer or representation for the action.”

D. Is this a Reverse Eggshell Audit ?

1. Once the Agent suspects fraud during the civil exam, and he or she refers the case to CI, CI may conduct a joint criminal and civil investigation.⁶
2. Alternatively, a joint criminal and civil examination can be initiated by CI because there is already an ongoing criminal investigation and CI requests that an examiner be assigned to the investigation.⁷
3. Parallel investigation - Certain entities or tax years are subject to a criminal investigation while related entities or other tax years are the subject of a simultaneous civil audit.⁸
4. The benefit to the government of this type of joint investigation is that it allows the government to use the investigative tools of a civil audit, like administrative summonses and examinations of returns, without the invocation of due process, the right against unreasonable searches and seizures, the right against self-incrimination, and the right to counsel.⁹
5. The danger to the taxpayer is that the taxpayer believing that he or she is complying with the audit may waive his or her constitutional rights and attorney-client privilege.¹⁰
6. Unlike the eggshell audit, where the goal of the practitioner is to seek to avert a criminal investigation by keeping the examiner in the dark about

the fraud, in a reverse eggshell audit, the practitioner is the one in the dark, seeking to discover whether there is a simultaneous criminal investigation.¹¹

- E. Potential criminal statutes at issue.
 - 1. Tax Evasion - IRC §7201.
 - 2. Willful Failure to Collect or Pay Over Tax - IRC § 7202.
 - 3. Willful Failure to File Return, Supply Information or Pay Tax. IRC § 7203.
 - 4. False Returns and Preparers of False Returns - IRC § 7206.
 - 5. Submitting False Documents - IRC § 7207
 - 6. Attempts to interfere with Administration of Internal Revenue Laws - IRC § 7212(a).
- F. What are the Revenue Agent's audit issues?
 - 1. Let the Revenue Agent (RA) guide the audit: Do not volunteer issues!
 - 2. Review IRM Audit Techniques for business returns.
 - 3. Review IRS's Audit Techniques Guides (ATG) for industry specific issues.
- G. What are the Revenue Agent's tools for gathering information?
 - 1. Information Document Requests (IDR) - Tax practitioner should produce documents if its in the client's best interest.
 - 2. Summons and subpoenas: The IRS may issue such request for the

purposes of ascertaining the correctness of any return.

- a. Pursuant to the subpoena power, the IRS may :
 - (1) Examine any books and records
 - (2) Summon the person liable for tax or any officer or employee of such person, or any person having possession, custody or care of books or records.
3. To enforce a summons the IRS must show that the summons :
 - a. Was issued for a legitimate purpose;
 - b. Seeks information relevant to that purpose;
 - c. Seeks information that is not already within the IRS' possession;
and
 - d. Satisfies all administrative steps required by the United States Code.
4. Limitations on IRS subpoena power:
 - a. Attorney-Client Privilege
 - (1) Kovel doctrine - The attorney-client privilege and work product privilege is extended to the accountant under Kovel. See US v. Kovel, 296 F. 2d 918 (2nd Cir. 1961).
 - b. Tax Practitioner's Privilege
 - c. Attorney Work Product Privilege
 - d. Third Party Contacts/ Summonses

- e. The Agent is required to notify the taxpayer of any third-party contacts within three days following the contact.

H. Taxpayer's Rights in Reverse Eggshell Audits

1. The IRS has an affirmative duty to disclose the criminal nature of a civil examination when the taxpayer's representative directly asks whether a criminal investigation is underway. See U.S. v. Tweel, 550 F.2d 299 (5th Cir. 1977).
2. In Tweel, the taxpayer's accountant asked the examining revenue agent whether a "special agent" was involved in the investigation. The revenue agent answered that no special agent was involved. While the agent answered truthfully that no special agent was involved, the audit was conducted to acquire evidence for a criminal prosecution. Thus, the revenue agent's response "materially deceived" the taxpayer into providing incriminating information to the IRS.¹²
3. Before answering a summons or turning over documents, consider asking the Revenue Agent the following questions:¹³
 - a. Is there a parallel or sub rosa criminal investigation?
 - b. Has this matter been referred to the fraud coordinator?
 - c. If so, what guidance has been given by the fraud coordinator?
 - d. What information has been provided to the fraud coordinator, and by the fraud coordinator?

4. Taxpayer can also refuse to answer a summons by taking the Fifth and exercising his or her constitutional privilege not to incriminate himself or herself. ¹⁴

I. Signs of Criminal Referral ¹⁵

1. Undue interest
2. Excessive copying
3. Questions on intent of taxpayer
4. Bank records analysis
5. Net worth analysis
6. The disappearing agent - The Revenue Agent stops discussing the status of the audit or disappear.

III. Methods the IRS Uses for Determining Additional Tax Liability

- A. Specific Items - Deductions or omitted income will be reflected on the Revenue Agents' Report (RAR).
- B. Indirect Methodologies
 1. Net Worth Method
 - a. The net worth method is used when the IRS believes that the taxpayer's records do not accurately reflect his/ her income.
 - b. Example: Taxpayer's net worth at the beginning of a period (one or more years) Less: Taxpayer's net worth at the end of a period;
Plus: Taxpayer's nondeductible expenditures during the period ;

Less: Income (or asset receipts) from nontaxable sources (i.e., gifts) ; Yields: Taxpayer's income during the period.

2. Bank Deposits and Expenditures Method

- a. The IRS reconstructs income by assuming that unexplained bank deposits are taxable income.
- b. Example: All of the deposits to the taxpayer's bank account(s) during the period; Less: Deposits shown to be nontaxable income (such as gifts); Plus: All know expenditures which were not from the bank account(s); Less: All expenditures which are deductible; Yields: Taxpayer's taxable income during the period.

IV. Following the Audit: Settlement Attempts

- A. The Revenue Agent may be willing to settle based upon a dollar-figure amount, or may be willing to settle on an issue-by-issue basis.
- B. Identify the strong v. weak issues, and the important v. non-important issues, and decide which are worth conceding to achieve a settlement.
- C. If a settlement is not reached, request a copy of the Revenue Agent's Report (RAR).

V. Protesting the Determinations

- A. The Revenue Agent will first send a 30-Day letter, then a 90-Day letter.
- B. The 30-Day letter gives the Taxpayer a right to an Appeals Hearing; The 90-Day Letter gives the Taxpayer a right appeal to US Tax Court.

- C. If the taxpayer disagrees with the findings and files a petition, Chief Counsel will refer the case to Appeals for consideration, if Appeals has not had a chance to review the case yet and the case has not been docketed.

1. IR-2010-13, January 26, 2010.

2. Ibid.

3. Ibid.

4. Ibid.

5. IRS Announcement 2010-09.

6. IRS Fraud handbook.

7. IRM Section 25.1.4.1

8. Schainbaum, Martin A. "The Reverse Eggshell Audit: The Dangers of Parallel Proceedings." October 2005. <http://www.taxwarrior.com/articles/the_reverse_eggshell_audit.html>

9. Ibid.

10. Ibid.

11. Schainbaum, Martin A and Smith, Bryant. "Parallel Investigations: The Unclear Present Danger of Getting Caught." December 2008-January 2009. Journal of Tax Practice & Procedure.

12. See Schainbaum, Martin.

13. Ibid.

14. Ibid.

15. Campagna, Larry, "How to Beat the IRS in a Civil/ Criminal Case," pg 8. November 2002. <<http://www.tjtaxlaw.com/20021100%20Campagna%20Outline%20on%20Eggshell%20Audits%20%28TJ138%29.pdf>>. Last visited 4/19/2010.

Form **4822**

(Rev. 6-83)

Department of the Treasury - Internal Revenue Service

STATEMENT OF ANNUAL ESTIMATED PERSONAL AND FAMILY EXPENSES

TAXPAYER'S NAME AND ADDRESS

Jofin Doe
2222 Wisteria Lane
Montclair, NJ 07043

TAX YEAR ENDED

2007

ITEM		BY CASH	BY CHECK	TOTAL	REMARKS	
1. PERSONAL EXPENSES	Groceries and outside meals			\$ 35,600.00	From Amex paid in 2007	
	Clothing			\$ 6,000.00		
	Laundry and dry cleaning					
	Barber, beauty shop, and cosmetics			\$ 15,000.00		
	Educating (Tuition, room, board, books, etc.)					
	Recreation, entertainment, vacations					
	Dues (clubs, lodge, etc.)					
	Gifts and allowances					
	Life and accident insurance					
	Federal Taxes (income, FICA, etc.)					
2. HOUSEHOLD EXPENSES	Rent					
	Mortgage payments (including interest)			\$ 20,400.00	Mortgage Int/RefTax Sch A	
	Utilities (electricity, gas, telephone, water, etc.)			\$ 4,800.00		
	Domestic help			\$ 5,200.00		
	Home insurance			\$ 1,500.00		
	Repairs & improvements					
	Child care					
3. AUTO EXPENSES	Gasoline, oil, grease, wash			\$ 2,500.00		
	Tires, batteries, repairs, tags					
	Insurance			\$ 1,200.00		
	Auto payments (including interest)					
	Lease of auto			\$ 12,000.00		
4. DEDUCTIBLE ITEMS	Contributions					
	Medical Expenses	Insurance				
		Drugs			\$ 1,000.00	
		Doctors, hospitals, etc.				
	Taxes	Real estate (not included in 2. above)				
		Personal Property				
		Income (State and local)			\$ 27,278.00	Fed: \$22,354; State: \$1,099
	Interest (not included in 2. and 3. above)				SS on 4W-2 \$3,825	
	Miscellaneous	Alimony				
		Union dues				
5. PERSONAL ASSETS, ETC.	Stocks and bonds					
	Furniture, appliances, jewelry					
	Loans to others					
	Boat					
TOTALS		\$ -	\$ -	\$ 132,478.00		

FORM 4822 (Rev 6-83)

Exhibit 2

To: Client
From: Calo Agostino, A Professional Corporation
Date: October 4, 2008
Re: Questions for Taxpayers & Return Preparer

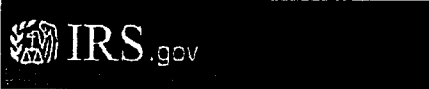
- (1) Occupation and qualifications of preparer
 - a. Education
 - b. Experience
 - c. Enrolled
- (2) Description of primary books and records in detail
 - a. Cash receipts and disbursements book
 - b. Journals: sales, purchases, cash
 - c. Invoices and other original documents
- (3) Description of secondary books and records in detail
 - a. Ledgers: general and subsidiary
 - b. Trial balance books, and records of financial statements
- (4) Extent of witness' audit of books and records

- (5) Source of all information on returns
 - a. Books and records (tie in with return)
 - b. No records (obtain information in detailed form)
 - c. Oral information
 - d. Records and books of other third parties
- (6) Items not shown on books or records (including income, assets, etc.)
- (7) Instructions and data received from taxpayer and any other persons
- (8) Information as to whether returns were explained to taxpayer, and to what extent
- (9) Copies of workpapers used in preparation of returns and copies of returns
 - a. Tie in with return
 - b. Supporting data
 - c. Arrange to inspect the workpapers and copies of returns
- (10) Conversations regarding tax matters with:
 - a. Taxpayer
 - b. Taxpayer's agent or other persons

(11) Details about witness' and taxpayer's knowledge concerning the signing and filing of each return, including:

- a. Identification of each return prepared by witness
- b. Where each return was prepared
- c. Where each return was signed

Exhibit 3



Audit Techniques Guides (ATGs)

The Audit Techniques Guides (ATGs) focus on developing highly trained examiners for a particular market segment. These Guides contain examination techniques, common and unique industry issues, business practices, industry terminology and other information to assist examiners in performing examinations. Audit Techniques Guides are available here in [Adobe PDF](#), or as HTML Web pages, or both. The PDF versions must be viewed with the [Acrobat Reader](#).

NOTE: These guides are current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of these documents, no guarantees are made concerning the technical accuracy after the publication date.

A B C D E F G H I J K L M N O P Q R S T U V W X Y Z

Accuracy - Related Penalties For Taxpayers Involved in Tax Shelter Transactions - (Obsolete)

Publication Date:

As of July 1, 2008, this audit technique guide ("ATG") has been obsolete. The information from this guide has been incorporated into IRM 20.1.5 "Return Related Penalties." For additional information, visit the [Part 20, Penalty and Interest Web page](#).

Aerospace Industry

([HTML View Online](#))

Publication Date: 01/05

The Service has prepared a comprehensive audit technique guide to assist examiners in evaluating research credit in the aerospace industry. The guide focuses on the particular unique aspects of the industry and provides examiners tools and tests to utilize in evaluating and auditing research credit.

Air Transportation Audit Technique Guide (ATG) (PDF - 593K)

([HTML View Online](#))

Publication Date: 04/08

Overview of excise tax paid for transportation of persons or property by air.

Child Care Provider Audit Technique Guide

([HTML View Online](#))

Publication Date: 3/30/2009

The Child Care Provider Audit Technique Guide is intended to provide guidance to the examiner who is auditing a taxpayer in this industry and to provide tax related guidance to taxpayers and other professionals in this industry.

Coal Excise Tax (PDF - 258K)

([HTML View Online](#))

Publication Date: 05/05

Provides excise tax agents with specific tools to examine issues relating to domestically produced coal.

Commercial Banking (PDF - 701K)

Publication Date: 5/01

Overview of the industry. Discusses potential issues and terminology unique to banking.

Construction Industry

([HTML View Online](#))

Publication Date: 05/09

Overview of the industry including a glossary. Discusses types of contracts; types of contractors; methods of accounting; and joint ventures. This updated guide includes the filing locations for Rev. Proc. 92-29 elections (Chpt 7); includes contractor square footage costs (Chpt. 11); and common errors in look-back interest filings (Chpt. 5).

Cost Segregation Audit Techniques Guide

([HTML View Online](#))

Publication Date: 01/14/05

The Service has prepared a comprehensive audit techniques guide to assist examiners in evaluating cost segregation studies submitted by taxpayers in support of depreciation deductions. The guide is also beneficial for taxpayers and practitioners in preparing these studies.

Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC 641 (PDF - 116KB)

([HTML View Online](#))

Publication Date: 06/05

This Audit Techniques Guide sets forth the Research Credit Technical Advisors' suggested guidelines for auditing research credit issues.

Executive Compensation - Fringe Benefits Audit Techniques Guide

([HTML View Online](#))

Publication Date: 02/04/05

Corporate executives often receive extraordinary fringe benefits that are not provided to other corporate employees. Any property or service that an executive receives in lieu of or in addition to regular taxable wages is a fringe benefit that may be subject to taxation.

Factoring of Receivables Audit Techniques Guide (PDF - 32KB)

([HTML View Online](#))

Publication Date: 06/06

This audit techniques guide focuses on a strategy in which multinational corporations use factoring of accounts receivable among related parties to avoid U.S. taxation by shifting income offshore and reducing U.S. income by deducting expenses related to the same income.

Farmers Audit Techniques Guide (ATG)

[\(HTML View Online\)](#)

Publication Date: 07/06

The Agriculture Industry Audit Techniques Guide (ATG) focuses on developing highly trained examiners for the Agricultural market segment. The Guide contains examination techniques, common and unique industry issues, business practices, industry terminology and other information to assist examiners in performing examinations.

Foreign Insurance Excise Tax Audit Techniques Guide (PDF - 434K)

[\(HTML View Online\)](#)

Publication Date: 04/08

This audit techniques guide was designed to assist the examiner in conducting audits where Excise Tax of Foreign Insurance transactions may be due.

Golden Parachutes Audit Techniques Guide

[\(HTML View Online\)](#)

Publication Date: 02/04/05

The Service has prepared a comprehensive audit techniques guide to assist examiners in evaluating parachute examinations. The parachute examination can occur during the examination of either the corporation's or the individual's return.

Hardwood Timber Industry (PDF - 366K)

Publication Date: 2/98

Provides general and technical information useful to examiners in classifying, preplanning and examining returns relating to this industry.

Inland Waterways

[\(HTML View Online\)](#)

Publication Date: 12/08

This audit technique guide is intended to provide assistance to the examiner who is auditing a taxpayer for which the use of the Inland Waterways is an issue.

IRC 162(m) Salary Deduction Limitation Audit Techniques Guide

[\(HTML View Online\)](#)

Publication Date: 02/04/05

Every publicly held corporation maintains its executive compensation records differently. Likewise, every publicly held corporation maintains different methods for compensating its executives. As the examining agent, you must first learn the identity of the individual(s) within the corporation who are most familiar with how the executive compensation records are maintained.

IRC § 183: Activities Not Engaged In For Profit Audit Techniques Guide

[\(HTML View Online\)](#)

Publication Date: 06/19/09

This audit technique guide (ATG) has been developed to provide guidance to Revenue Agents and Tax Compliance Officers in pursuing the application of IRC § 183, Activities Not Engaged in for Profit (sometimes referred to as the "hobby loss rule").

The Laundromat Industry (PDF - 126K)

Publication Date: 6/00

Provides an explanation of water consumption analysis for reconstructing unreported income from the operation of a laundromat. This method is to be used only when there is a reasonable indication of unreported income.

Lawsuit Awards and Settlements (PDF - 380K)

[\(HTML View Online\)](#)

Publication Date: 01/01

This guide focuses on taxability of lawsuit awards and settlements.

Ministers Audit Technique Guide

Publication Date: 04/23/09

The Ministers Audit Technique Guide is intended to provide guidance to the examiner who is auditing a taxpayer who is a minister and to provide tax-related guidance to taxpayers and other professionals in this industry.

New Vehicle Dealership Audit Technique Guide (PDF - 1.99 MB)

[\(HTML View Online\)](#)

Publication Date: 1/05

This guide will give you the key to a quick and competent closure of any new vehicle dealership examination which hinges on narrowing the scope of the examination to items that may prove productive.

Non-Qualified Deferred Compensation Audit Technique Guide

[\(HTML View Online\)](#)

Publication Date: 02/04/05

The Service has prepared a comprehensive audit techniques guide to assist examiners in evaluating non-qualified deferred compensation. A nonqualified deferred compensation (NQDC) plan is any elective or nonelective plan, agreement, method, or arrangement between an employer and an employee (or service recipient and service provider) to pay the employee compensation some time in the future.

Obligations Not in Registered Form Audit Technique Guide (ATG) (PDF - 275K)

[\(HTML View Online\)](#)

Publication Date: 6/06

Obligations Not in Registered Form**Obligations Not in Registered Form D Audit Technique Guide (ATG) (PDF - 84K)**[\(HTML View Online\)](#)**Publication Date:****Obligations Not in Registered Form D****Oil and Gas Industry (PDF - 494K)****Publication Date:** 5/96

Provides information on basic operations and common terminology. Includes reference to royalty owners and an introduction to financial products.

Ozone Depleting Chemicals (ODC) Excise Tax Audit Techniques Guide (PDF - 412K)[\(HTML View Online\)](#)**Publication Date:** 9/07

This is the Audit Techniques Guide for Ozone Depleting Chemicals (ODC).

Partnerships[\(HTML View Online\)](#)**Publication Date:** See Table of Contents for Publication/Revision Date of the Individual Chapters

The focus is on issues that fall within sections 701 through 761 of the Code (Subchapter K). Subchapter K deals primarily with the formation, operation, and termination of partnerships. Many issues arise during the initial or final year of the partnership.

Passive Activity Losses (PDF - 3437 K)[\(HTML View Online\)](#)**Publication Date:** 02/05

Provides examiners with specific guidance on potential audit issues, issue identification and lead sheets and other job aids.

Placer Mining (PDF - 181K)[\(HTML View Online\)](#)**Publication Date:** 7/99

Provides guidelines for the examination of taxpayers in this industry. Focuses on small mining operations represented as sole proprietorships on Schedule C, but can be adapted for partnership and corporate returns.

The Port Project (PDF - 262K)**Publication Date:** 8/95

Provides examiners assistance in auditing industries related to coastal and inland waterways.

Poultry Industry (PDF - 1568K)**Publication Date:** 12/02

The purpose of this guide is to highlight issues that are specific to or have a large impact on the poultry industry. Most of the issues in this guide relate directly to the major companies rather than the individual farmers. However, one chapter has been devoted to the issues normally found in conjunction with a poultry grower audit.

Reforestation Industry (PDF - 120K)[\(HTML View Online\)](#)**Publication Date:** 8/95

Overview of the industry. Discusses some issues that may be encountered - including employment taxes; poor accounting records; etc.

Rehabilitation Tax Credit (PDF - 353K)**Publication Date:** 12/02

Provides examiners with audit aids (i.e. issue checksheet, pro forma Information Document Request, and standardized audit reports, etc.) which assist in identifying and addressing common rehab tax credit issues.

Research Credit Claims Audit Techniques Guide (RCCATG): Credit for Increasing Research Activities § 41[\(HTML View Online\)](#)**Publication Date:** See table of contents for publication/revision date for the individual chapters, exhibits, and letters & forms. This guide provides guidance on the handling and evaluation of research credit claims.**Retail Industry (PDF)**[\(HTML View Online\)](#)**Publication Date:** 2/09

Overview of the Retail Industry.

Sections 48A and 48B - Advanced Coal and Gasification Project Credits[\(HTML View Online\)](#)**Publication Date:** 5/09

Section 46 provides that the amount of investment credit for purposes of § 38 for any taxable year is the sum of the credits listed in § 46. Section 1307(a) of the Energy Tax Incentives Act of 2005, Pub. L. 109-58, 119 Stat. 594 (August 8, 2005), amended § 46 to add two new credits to that list: The qualifying advanced coal project credit, (section 48A) and the qualifying gasification project credit, (section 48B).

Split Dollar Life Insurance Audit Techniques Guide[\(HTML View Online\)](#)**Publication Date:** 03/07/05

Split-dollar life insurance arrangements can be a key feature of executive compensation packages. Over the years, the Service has provided limited guidance regarding the taxation of these arrangements. Beginning in 2001, transitional guidance on the valuation of split-dollar life insurance arrangements was provided in the form of notices and proposed regulations in anticipation of final regulations.

Sports Franchises (PDF file under revision)

Publication Date: 8/99

Focuses on major league franchises. Potential issues may include revenue (sponsorship, broadcast, season tickets), strike fund payments, stadium issues, player contracts, purchase/sale of franchise, league expansion, etc.

Stock Based Compensation Audit Techniques Guide

[\(HTML View Online\)](#)

Publication Date: 02/04/05

The Service has prepared a comprehensive audit techniques guide to assist examiners in evaluating stock-based compensation. Stock-based compensation generally consists of either the transferring of stock or the issuance of stock options to an employee or independent contractor.

Structured Settlement Factoring Audit Technique Guide (ATG) (PDF - 180)

[\(HTML View Online\)](#)

Publication Date: 11/06

Structured Settlement Factoring

Swine Farm Industry (PDF - 920KB)

Publication Date: 12/02

Overview of the industry includes methods of accounting (accrual vs. cash), farm price inventory, unit livestock price, prepaid feed, income from discharge of indebtedness, selection fees, depreciation, grower issues, penalties, research credits, employment taxes, and excise taxes.

Tobacco Industry (PDF - 174K)

Publication Date: 3/96

Focuses on techniques for examining tobacco farmers, dealers and warehouse operations.

Veterinary Medicine (PDF - 495K)

[\(HTML View Online\)](#)

Publication Date: 4/05

Overview of industry includes discussion of types of business entities (especially personal service corporation); cash vs. accrual method of accounting; and inventory vs. supplies.

Rate the Small Business and Self-Employed Web Site

Page Last Reviewed or Updated: August 27, 2009

Exhibit 4



Part 4. Examining Process

Chapter 35. Partnership and S Corporations

Section 2. Audit Techniques for Business Returns

4.35.2 Audit Techniques for Business Returns

- 4.35.2.1 Overview
- 4.35.2.2 Preliminary Work at Taxpayer's Office
- 4.35.2.3 General Ledger, Examination Approach
- 4.35.2.4 Net Worth Section
- 4.35.2.5 Balance Sheet Approach to Examinations

4.35.2.1 (05-05-2006)

Overview

1. This chapter discusses audit techniques for business returns.

4.35.2.2 (05-05-2006)

Preliminary Work at Taxpayer's Office

1. The examination at the taxpayer's office may begin with miscellaneous records other than the actual ledgers and journals. Frequently, these records indicate items that the examiner should be alert for as the examination progresses.
2. The records and the type of information to be obtained are as follows.
 - A. Minute book – This corporate record should contain information on officer's salaries, real estate leases and sales, construction contracts, lawsuits, patent applications, the issuance of new stock, the purchase of Treasury stock, and information relating to restricted stock options. As the examiner stuns through the minute book, appropriate notes for future consideration should be made. The review of the minute book should not be confined to the taxable year under examination. It is advisable to cover at least some of the period immediately before and after. If necessary, the minute books should be obtained that go all the way back to the inception of the business. The correct name of the corporation should appear on the company charter that is usually kept in the minute book. This name is important when it becomes necessary to prepare a waiver to extend the statutory period of limitations. Large corporations maintain minutes of the executive committee in addition to the minute book.
 - B. Original partnership agreement for an operating agreement. If a partnership election is made by a Limited Liability Company and all subsequent amendments and changes – The provisions of this document should be noted. The distribution of income including partner's salaries and interest on capital and other allowances, which it may establish, should be checked against the partnership return. These allocations need to be analyzed to determine if they are proper under IRC section 704/52 rules.
 - C. S corporation election – The election should be reviewed to verify that (1) all shareholders at the date of the election signed the election and that the number of shareholders at the date of the election did not exceed the maximum number of shareholders, (2) all shareholders were individuals who were U.S. citizens or residents, estates, certain types of trusts, IRC section 501(c)(3) organizations or employee stock ownership plan (ESOP), (3) the corporation has only one class of stock and (4) the corporation is not an ineligible corporation as defined in IRC section 1361(b)(2).
 - D. Audit report of independent auditors – This report should be read. Where two reports were issued, one in detail for management and the other a condensed one for investors, the former should be secured. Income and net worth per this report may differ from income and net worth per books due to the auditor's adjusting entries not reflected on the books. Where this difference exists, these adjusting entries will be reconciling items between the books and the return. The auditor's workpapers usually explain these entries. They should be checked closely. Any qualifications or unusual comments in the auditor's report or certificates, such as expressions of opinion as to taxpayer's depreciation policy, adequacy of reserves, status of collectability of receivables and the like, should be noted for consideration later when the items of income and expense are audited.
 - E. Auditor's workpapers – Audits, particularly of larger companies – may frequently be simplified if the examiner is given access to the auditor's workpapers. Judicious use of such records helps to reduce the time in examining the taxpayer's books. Examples of the types of analyses often found in such workpapers which may prove useful to the examiner are accounts receivable aging schedules, or repair analyses in which each expenditure over a certain amount is described. Guidelines for Requesting Accountants' Workpapers are contained in IRM 4.10.3.
 - F. Retained copy file of income tax returns – Preceding and succeeding years' tax returns should be inspected. Items to observe are: significant ratio variations between other years and the current year; such as gross profit ratios or selling expenses to sales. Where they vary widely from the current year the examiner should make a note to determine the cause as the taxpayer's records are being examined. Balance sheet ratios or trends should also be observed. Continuation in the year of examination of prior elections concerning bad debts, inventory valuation methods, depreciation rates and methods, etc. should be verified. Prior or subsequent year entries in the reconciliation schedules of retained earnings and the accumulated adjustments account and other adjustments account on a corporate return or of partners' capital accounts on a partnership return which affect the year under examination should also be reviewed. Retained copies of other prior year returns may be useful in certain cases, such as those requiring determination of the status of the retained earnings account, the basis of assets and depreciation allowed or allowable and the shareholder's stock basis or the partner's partnership basis.
 - G. Stock transfer book – This book contains the names of present and past stockholders with the number of shares owned and the dates issued or cancelled.
 - H. Statements and schedules filed with regulatory bodies – Companies in the public utility field are required to file certain data with regulatory agencies, such as the Interstate Commerce Commission, Civil Aeronautics Board, and State and local utility commissions. These schedules are detailed and can at times save the examiner considerable analytical work. Rules of accounting which public utility enterprises are required to adopt by regulatory commissions are not controlling for Federal income tax purposes.
 - I. Financial statement for credit purposes – Financial statements furnished grantors of dealer franchises – Comparison of such statements with the tax return balance sheet and income statement schedule may reveal significant variances. For instance the reserve for bad debts on a balance sheet furnished a bank or a credit agency may be smaller than the reserve shown on the return balance sheet. This may indicate the reserve on the return is too high.
 - J. Appraisals – Engineers' and real estate dealers' appraisals are important in many cases, particularly in allocating real estate costs between land and building. In addition, art dealer appraisals may be useful in valuing works of art.

4.35.2.3 (05-05-2006)

General Ledger, Examination Approach

- The accounts contained in the general ledger will provide the examiner with an insight into the operations of the business. The chart of accounts should be requested from the taxpayer. If a private ledger is maintained, it should also be requested.
- The examiner should obtain an adjusted trial balance. An adjusted trial balance is a list of all general ledger accounts and the year end balance. The adjusted trial balance should be reviewed for unusual account balances. Also, it is a quick indication of the amount of accrued liabilities the taxpayer has claimed. Examination of the liability accounts is addressed in section 2.5.2 of this manual. The examiner should be aware of all account balances with a credit balance. Even though they may be classified as an asset, a credit balance in an asset account is an indication it is in reality a liability account. An example is the bad debt reserve. It is normally recorded as a contra asset account, which is the same as a liability account.
- As the examiner goes through the ledger unusual or nonrecurring items should be noted. Such items fall roughly into three classes.
 - Unusual in amount** -- The examiner should be alert for month-end entries of like amounts which represent large expense items which have been debited to a deferred account and spread over several months to avoid attracting attention. The total amount of an account may be unusual in amount because it appears to be too small. For example, where there is a small repair account total in a year under examination and the taxpayer had substantial fixed assets, the small repair total may be indicative of the practice of charging repairs to other accounts less likely to be checked. The manufacturing expense account is one potential alternative for such repair charges.
 - Unusual by source** -- Source as used here means the journals from which the account was posted, as indicated in the folio column. There is a normal source pattern for most postings. Repairs or advertising expenses are generally posted from the cash disbursement journal or the purchase journal; if the folio column indicates a cash receipts journal or general journal source it may warrant a further check. Entertainment expense items from the general journal more often than not represent officers' expense. Fixed asset credits from the cash book are unusual, if the assets were sold, a general journal entry is the normal way to eliminate the cost of the asset from the books. A cash book source suggests that the total selling price instead of the cost was credited to the account. These are a few of the possible source variations. The examiner should be alert for the many more items that may be encountered.
 - Unusual by nature** -- An entry in a ledger account may be unusual by nature as well as by an account itself. Some examples of unusual entries and accounts are: Credit entries in accounts that usually contain only debits or vice versa. As an example a debit to a sales account could possibly be a bad debt write-off. Accounts that exist at the beginning of the year but do not exist at the end. For instance, the existence of a supplies inventory at the beginning of the year and no inventory at the end may indicate that the taxpayer had made an unauthorized change in the method of accounting. Conversely, the existence of an account at the end of the year, where none existed at the beginning, such as accrued wages, may indicate a similar unauthorized change. A general ledger in which the nominal accounts are not closed out to the income summary account at the end of the year, where the situation exists, and the necessary information is not available from the auditor's worksheets, the examiner should trace the account to the tax return. This audit approach is advisable so that the examiner will uncover adjustments to the accounts that are not reflected by entries on the books.

4.35.2.4 (05-05-2006)

Net Worth Section

- Consider the following information when examining net worth.

4.35.2.4.1 (05-05-2006)

Purpose and Scope of Examiner's Analysis

- The principal purpose of an income tax examination is the verification of the taxable income shown on a particular tax return. That taxable income is the end product of the various items of income and expense on the return. Any one of these items may be an accumulation of from one to thousands of individual transactions. These individual transactions do not appear on the tax return. Accordingly, it becomes necessary to examine them in the place where they do appear and that is in the books.
- Since the transactions are recorded on the books according to accounting principles rather than tax law, it is likely that there will be some differences between the net income on the books and the net income on the tax return. The examiner must isolate and reconcile these differences.
- If a questionable item is noted in the taxpayer's books during the examination of an income or expense account, the examiner should analyze the reconciliation from net book income to net income per return to determine if the item was eliminated from the amount deducted on the tax return.
- The net worth section is the starting point in determining the relationship of the books and the return. There are three elements in this section at the end of any given tax year. They are:
 - the net worth at the beginning of the year;
 - the operating income or loss of the current year;
 - the non-operating transactions of the current year.
- The examiner is primarily concerned with the second element. However, since the books and the returns may vary, the examination should not be confined only to the second element. Items, which fall in the second element on the books, may belong in either of the other two insofar as the tax return is concerned, and vice versa. The examiner must therefore check all three elements.
- Having defined the scope and purpose of the net worth analysis and the income reconciliation, the manner in which they are to be accomplished is the next step. In some respects the manner varies depending on the entity involved. The corporate taxpayer will be considered first.

4.35.2.4.2 (05-05-2006)

S Corporations

- Like a C corporation balance sheet, the net worth of an S corporation is composed of the capital account and retained earnings account. The difference is there is no reconciliation of the retained earnings account on an S corporation return. The Schedule M-2 on a C corporation is the reconciliation of the retained earnings account while the Schedule M-2 on an S corporation return is the analysis of the Accumulated Adjustments Account (AAA), Other Adjustments Account (OAA) and Shareholder's Undistributed Taxable Income Previously Taxed (PTI). The OAA will only be used if the S corporation has tax exempt income and or expenses related to tax exempt income. The PTI account will only be used if the S corporation was in existence prior to 1983 and has income that has been taxed on the shareholder's return, but has not been distributed to the shareholder or S corporation losses accumulated prior to 1983.
- The purpose of Schedule M-2 is to track the income, losses and separately stated items that should have been reported on the shareholder's tax returns.
- The examiner should remember that the retained earnings account on the S corporation balance sheet is a book number and more than likely will not tie to the amounts in the AAA, OAA and PTI, which are tax numbers. The main difference will be timing differences between book and tax. For example, if the book depreciation is less than the tax depreciation, the retained earnings account on the balance sheet will be larger than the AAA balance.
- Since there is no reconciliation of the book retained earnings account shown on an S corporation return, as there is on a C corporation return, the following reconciliation should be made:

Beginning Ending Retained Earnings xxx
 Book Income/Loss (Schedule M-1, Line 1) xxx
 Less: Distributions xxx
 Subtotal xxx

Ending Retained Earnings xxx

Difference 000

5. If the difference amount is not zero, a reconciliation should be obtained. There are two possible reasons for a difference, (1) The amounts on the balance sheet are wrong so the balance sheet cannot be relied on, or (2) There was an entry made directly to the retained earnings account. This would be known as an M-2 adjustment on a C corporation. As with a C corporation, any amount entered directly into the retained earnings account has by-passed the income statement and taxable income. All entries made directly to the retained earnings account should be examined to determine if taxable income is being avoided.
6. Sometimes the distribution section of the Schedule K and the AAA are not completed or are completed incorrectly. Using the above formulas will detect the potentially incorrect entries on the Schedule K and AAA. If it is assumed that no entries were made directly to the retained earnings other than actual distributions, the amount of the distribution can be determined using the above formulas. The preparer should always be asked to reconcile any differences brought out with the use of the above formulas.

4.35.2.4.3 (05-05-2006)**Partnerships**

1. There is no great difference in principle between the net worth analysis of a corporation and a partnership. The same technique applies to both. However, relative to partnerships, the examiner must first ascertain the method of accounting used to complete the 1065 Balance Sheet. In many instances, the balance sheet of Form 1065 is prepared based on Fair Market Value to coincide with Partnership Allocation Rules. The examiner can make this determination by reviewing Part II, Block M of schedule K-1. In such instances where the balance sheet of Form 1065 was prepared based on Fair Market Value, the examiner should solicit a tax basis balance sheet from the taxpayer prior to conducting a net worth analysis.
2. Schedule M, Reconciliation of Partners' Capital Accounts. Form 1065, is a rough equivalent of Schedule M-1. Reconciliation of Income (Loss) per Books with income per return, and Schedule M-1 Analysis of Unappropriated Retained Earnings per Books on the corporate return, Form 1120, with income per return, and Schedule M-2, Analysis of Unappropriated Retained Earnings and Undivided Profits per Books, on the corporate return, Form 1120As stated in (1) above, the examiner must first identify the method of accounting used to complete the 1065 Balance Sheet.
3. Schedule K shows total distributive partnership items. Schedule K-1 reflects each partner's share of income, deductions, or credits that are required to be set out separately by the partnership. The schedule provides for the segregation of IRC section 1231 transactions. The examiner should remember that the decision on whether gain or loss on such assets is ordinary or capital should be deferred until transferred into the partners' individual returns. For each at risk activity, Schedule K-1 requires the entry of the partner's share of partnership liabilities for which the partner is personally liable. Examiners should be aware of at-risk limitations of losses on certain tax shelter partnership investments. Examiners should be alert for situations where taxpayers have claimed deductions for account interest on existing liabilities and foreclosure proceedings have subsequently occurred. Verify that the taxpayer has included the difference between the liability per books and the liability that was relieved by the foreclosure as income or gain (depending on the nature of the debt and if the underlining asset was disposed of).
4. Since Schedule M on the partnership return is condensed, the examiner should first secure the taxpayer's workpapers showing how various items were grouped for the schedule. Once this breakdown is secured the examiner can reconcile the books with the return. The per return column can be prepared solely from Schedule M as allocated in the workpapers; and from Schedule D Sale or Exchange of Property, Form 4797, Supplemental Schedule of Gains and Losses; and Schedule K of the return. The per books column detail should be secured from the taxpayer and then checked against the books to see that they agree.
5. After the reconciliation has been made, the examiner should continue with the examination bearing in mind the effect the above reconciling items have on the transactions appearing in the books. For instance, if there is a \$ 1,000.00 charge to charitable contributions, the examiner should remember that the \$ 1,000.00 was not claimed on the tax return. If the examiner sees an additional \$ 200.00 contribution to another organization the examiner would know that it was claimed on the return and should be adjusted.
6. The regulations under IRC section 6050K require partnerships to file Form 8308 (Report of a Sale or Exchange of Certain Partnership Interests) when a portion of any money or other property given to a selling partner in exchange for all or part of the partner's interest in the partnership is attributable to unrealized receivables or substantially appreciated inventory items (IRC section 751(a)). IRC section 6050K is effective for sales or exchanges occurring after 12/31/84. During their examination of partnerships, examiners will verify that all required Form 8308's have been filed. If they have not been filed, the appropriate penalties for failure to file these forms will be imposed, unless reasonable cause is found to exist. Examiners will also give consideration to securing within the district affected partners' returns to determine if examination is warranted, and preparing information reports on out-of-area partners.

4.35.2.5 (05-05-2006)**Balance Sheet Approach to Examinations**

1. See the following sections that explain the balance sheet approach to examinations.

4.35.2.5.1 (05-05-2006)**Examination of Asset Accounts**

1. See the following sections that explain the examination of the asset accounts.

4.35.2.5.1.1 (05-05-2006)**Introduction**

1. Thus far, this chapter has presented a series of suggestions on the technique of commencing the examination of a set of books and records. The initial phase includes a verification that the net income per books with appropriate reconciling adjustments, is actually reflected in the tax return under examination, whether it be a corporation, a partnership or a sole proprietorship.
2. Once this verification is completed, the examiner should turn attention primarily to the books and records, bearing in mind that there are some reconciling items that affect the net income per books.
3. The following subsections offer guides to the technique of examining the asset, liability, income, and expense accounts normally found in the general ledgers.

4.35.2.5.1.2 (05-05-2006)**Cash on Hand and in Bank**

1. Review the cash disbursements journal for a representative period. Note any missing check numbers, checks drawn to order of cash, bearer, etc.; large or unusual items, and determine propriety thereof through a comparison with vouchers, journal entries, etc.
 - A. In the case of a cash basis taxpayer, ascertain if checks were written and recorded which were issued after the close of the year under examination.
 - B. Give special consideration to checks issued for cashier's checks, sight drafts, etc., where the payee and nature are not clearly shown.
2. Obtain bank statements and cancelled checks for each bank account for one or more months, including the last month of the period under examination.
 - A. Compare deposits shown on the by bank statement against entries in cash receipt book.
 - B. Note year-end bank overdrafts in case of cash basis taxpayer. This may indicate expenses that are unallowable since funds were not available for payment.
 - C. Determine if any checks have remained outstanding for an unreasonable time. This may indicate improper or duplication of disbursements. Old outstanding checks possibly could be restored to income.

- D. Determine whether voided checks have been properly handled.
- E. For a test period, check endorsements to see if they are the same as payee, noting any endorsements by owner, or questionable endorsements.
- 3. Review the cash receipts journal for items not identified with ordinary business sales, being alert to such items as sales of assets, prepaid income, income received under claim of right, etc.
- 4. If records appear unreliable or have not been subjected to a competent independent audit, tests of footings and postings should be made for a representative period.
- 5. Investigate entries in the general ledger cash account. Look for unusual items that do not originate from cash receipts or disbursements journals. These entries may indicate unauthorized withdrawals or expenditures, sales of capital assets, omitted sales, undisclosed bank accounts, etc.
- 6. Test check some cash sales with the cash book to ascertain if they have been correctly recorded. Also check cash sales made at the beginning and end of the period under examination to determine if year-end sales have been recorded in the proper accounting period.
- 7. Test check disbursements from petty cash to determine if there are any unallowable items included.
- 8. Scrutinize cash overages and shortages, being alert to irregularities which may have cleared through accounts.
- 9. Review the cash on hand account to determine if there are any credit balances during the period under examination. This may indicate unrecorded receipts.

4.35.2.5.1.3 (05-05-2006)

Notes and Accounts Receivable

- 1. Check entries in the general ledger control accounts. Look for unusual items, especially those that do not originate from the sales or cash receipts journals.
- 2. Determine if subsidiary ledgers are in agreement with control accounts, and, if not, ascertain the reasons for any differences.
- 3. Note any credit balances in the general ledger or subsidiary accounts. This may indicate deposits or overpayments that could be considered as additional income or unrecorded sales.
- 4. Some credit sales invoices and postings should be test checked from the sales journal to the subsidiary and control account.
- 5. Determine whether accrued income on interest bearing notes or accounts has been included in income.
- 6. Where the taxpayer reflects an accrual method by subtracting beginning receivables and adding ending receivables to cash collected, consider checking the detailed listing of receivables at the beginning of the period to the cash receipts book. This may disclose diversion diverting of funds, etc. Determine if beginning receivables used in the computation are the same as the ending receivables of the preceding year.
- 7. Insure that the return conforms to the books in terms of its method of accounting.

4.35.2.5.1.4 (05-05-2006)

Investments

- 1. Analyze sales and other credit entries with regard to the following:
 - A. gains or losses (bets, wash sales, interest included in sales price, etc.);
 - B. other (exchanges, write downs, write-offs, transactions with related taxpayers, or controlled foreign entities, etc.).
- 2. Review debit entries. Consider such items as:
 - A. Non taxable securities acquired with borrowed funds.
 - B. Other acquisitions (transactions with related taxpayers, noncash acquisitions, creation, organization or reorganization of a foreign corporation, etc.).
- 3. Become familiar with the nature of investments, utilizing any records maintained by the taxpayer. Make necessary test checks to determine if related income has been properly reported (dividends, interest, etc.).
- 4. If shares of stock are held in a foreign corporation, determine whether it is a foreign personal holding company.
- 5. If the investment account is a negative amount, then the partnership or S corporation has most likely invested in another flow-through entity. The negative amount represents the excess of deductions over the capital contributed.

4.35.2.5.1.5 (05-05-2006)

Depreciable Assets

- 1. Determine whether assets shown on the depreciation schedule, which have a prior year acquisition date, are the same as shown on the tax return for the immediate preceding period. If not, this would indicate point up depreciation being taken on assets that have previously been expensed or fully depreciated, etc.
- 2. Review additions during the period. Test additions by reference to invoices, contracts, etc., giving consideration to the following.
 - A. Note items that appear to have originated from unusual sources such as appraisal increases, transfers, exchanges, etc., and determine propriety thereof. Ascertain if prior earnings were adequate to cover acquisitions.
 - B. Determine if costs relating to the acquisition and installation of assets, leasehold improvements, etc., have been capitalized.
 - C. Ascertain if assets include items of a personal nature.
 - D. Where construction or any other work of a capital nature is performed with the taxpayer's own equipment, labor, etc., for its own use, be certain that the basis of such asset includes the proper elements of material, labor and overhead, including depreciation.
 - E. With regard to the basis of assets, consider such items as trade-ins, acquisitions from related taxpayers, allocations of cost between land and building, etc. Also consider whether the basis has been reduced by the appropriate amount of investment credit for periods after December 31, 1982. Is a comment on ITC really important anymore?
- 3. Decreases in the asset accounts during the year should be noted. Gains or losses resulting therefrom should be verified.
 - A. Ascertain if the taxpayer has transferred assets to a controlled domestic or foreign corporation for less than fair consideration.
- 4. Examiners should be alert for situations where deductions are being claimed by entities leasing property to tax-exempt entities. As a result of the Deficit Reduction Act of 1984, certain tax benefits otherwise available (depreciation, investment credit), have been greatly reduced for owners of property that is leased to tax-exempt entities. Again, do we really care about a 1984 Tax Act?

4.35.2.5.1.6 (03-02-2006)

Valuation Reserves

- 1. Review nature and source of all accounts and ascertain whether they are being used as a means of diverting or

understating income, or claiming unallowable deductions.

2. Depreciation, Amortization, and Depletion Reserves – Determine whether any of these are contingent reserves. Check for reasonableness of any additions.

4.35.2.5.1.7 (05-05-2006)

Intangible Assets

1. Verify correctness of deductions claimed, such as amortization, write downs, write-offs, royalties, etc.
2. Test check current additions to determine if the basis includes the proper elements of cost, such as legal fees, application fees, etc.
3. Determine if there have been any transactions with related taxpayers, or controlled foreign entities; if so, consider arms-length features.
4. Determine if income applicable to intangibles has been included in income. In this regard connection be aware that it is not necessary for an intangible to have a basis or to appear on the records (e.g. subleases, overriding royalties, franchises, etc.).
5. Analyze any transaction involving transfer of foreign rights to any foreign entity for an equity interest, or for nominal consideration.
6. Be alert to any situation or transaction which logically could have given rise to an intangible which may have been expensed through inventories, fixed assets, expenses, etc. (e.g. purchase of a going business – which could involve good will, covenant not to compete, etc.).

4.35.2.5.1.8 (05-05-2006)

Prepaid Expenses and Deferred Charges

1. Determine Make check as to the nature and source of these assets, and the manner in which they are charged off to expense. Prepaid expenses are generally present in all businesses. The absence of such items should be considered, since a distortion of income may be involved.

4.35.2.5.1.9 (05-05-2006)

Other Assets

1. The nature and classification of other asset accounts should be considered to determine if they have a bearing on tax liability.

4.35.2.5.1.10 (05-05-2006)

Exchange, Clearing or Suspense Account

1. Determine the nature and purpose of the account. Test check debit and credit entries, being aware of the possibility that such an account may be used as a means for diverting sales, padding expenses, etc.

4.35.2.6.2 (05-05-2006)

Examination of Liability Accounts

1. See the following sections that explain the examination of the liability accounts.

4.35.2.6.2.1 (05-05-2006)

Current and Accrued Liability, Including Notes Payable

1. Review computation of year-end accruals with respect to their allowability as expenses or purchases. Verify that the economic performance requirement of IRC section 461(h) has been met along with the all events test. See that accruals set up at the end of the preceding year were either reversed in the current year or that the actual expenses were charged against them when paid. Be alert to large year-end items that have been shifted between years for the taxpayer's advantage.
2. Note any debit balances in the general ledger or subsidiary accounts. This may indicate diversion of funds, etc. Also note accounts that have long overdue balances. This may indicate contested liabilities and liabilities which no longer exist such as unclaimed wages, unclaimed deposits, items set up twice, etc.
3. Determine if subsidiary ledgers are in agreement with controls, and if not, ascertain the reasons for any differences.
4. Determine if accrued items payable to related taxpayers were paid within the time limit prescribed. Under IRC section 267, an accrual of an expense is not allowable if it is to a related taxpayer and that taxpayer is on the cash basis.
 - A. If the accrual is for compensation, even subcontractors, verify that it was actually paid within the first 2 1/2 months of the next year. See IRC section 404(a).
5. Investigate entries in the general ledger control accounts. Look for unusual items, especially those that do not originate from the voucher register or cash disbursements journals. This may disclose unreported income, improper or overstated expense.
6. Examiners should be alert for situations where taxpayers have claimed deductions for accrued interest on existing liabilities and foreclosure proceedings have subsequently occurred. Verify the taxpayer has included the difference between the liability per the books and the liability that was relieved by the foreclosure as income.
7. Analyze any newly established liability to a controlled foreign corporation as it may represent a constructive dividend.

4.35.2.6.2.2 (05-05-2006)

Officer's Salaries

1. Determine total compensation paid or accrued to principal officers, taking into consideration any compensation claimed under headings other than officers' salaries, such as manufacturing salaries, supervisory salaries, labor, etc., contributions to pension plans for the officers, payments of personal expenses, year-end or other bonuses, etc.
2. Determine if and to what extent each principal officer's compensation is unreasonable.
3.) The examiner should take into account such factors as: nature of duties, background and experience, knowledge of the business, size of the business, individual's contribution to profit making, time devoted, economic conditions in general, and locally, character and amount of responsibility, time of year compensation is determined, whether alleged compensation compensates in reality, in whole or in part, payment for a business or assets acquired, the amount paid by similar size businesses in the same area to equally qualified employees for similar services, etc.
4. Be alert to closely held multiple corporation situations in which compensation may be split between two or more related corporations, and which, in the aggregate, may be considered excessive to the officer-stockholder.
5.) In closely held corporations, determine that accruals payable to controlling stockholders are paid within the prescribed time limit. Under IRC section 267(e), no deduction is allowed for accrued compensation to an S corporation shareholder.
6. Determine if executives have received substantial bonuses under the guise that the proceeds would be used by the recipient to make significant political contributions.
7. Be aware of excessive compensation to S corporation officer/shareholders for the purpose of avoiding the built-in gains tax of IRC section 1374, avoiding taxable dividend distributions or shifting income amongst shareholders.
8. Be aware of inadequate salaries paid to officer/shareholders who receive substantial nontaxable distributions. S corporation earnings are not subject to the self-employment tax, so officer/shareholders often receive minimal small or no wages salary income to avoid employment taxes.

4.35.2.6.2.3 (05-05-2006)

Fixed Liabilities

1.) Financing arrangements such as mortgages, certificates of indebtedness, etc. are areas in which substantial adjustments are quite often found. The examiner should become acquainted with pertinent details with regard to such financing arrangements and consider possible adjustment areas as follows:
 - A. legal, professional and other expenses of issuance;
 - B. refunding of debt;
 - C. transactions with related taxpayers and controlled foreign entities;
 - D. related expense accounts (interest and amortization).
2. Scrutinize any long term outstanding liability to a controlled foreign corporation as it may represent an equity interest rather than a creditor interest.

4.35.2.5.2.4 (05-05-2006) Other Liabilities

1. The nature and classification of other liability accounts should be considered to determine if they have any bearing on tax liability. The accounts are often used to improperly defer revenue to a future period. The examiner should review and analyze the composition of the other liabilities account in conjunction with IRC section 451, IRC section 61 and the regulations thereunder to make a proper determination as to whether or not the amount reported as other liabilities should in whole or in part be a component of current revenue."

4.35.2.5.2.5 (05-05-2006) Capital Stock

1. Review all capital stock accounts – give adequate consideration to the following.

4.35.2.5.2.5.1 (05-05-2006) No Changes

1. No changes during period – Even though no changes in the total outstanding stock appear on the balance sheet or in the general ledger control accounts, consideration should be given to such features as:
 - A. Subchapter S Corporations. Is there a valid election, number and changes in stockholders, limitation on losses, etc.
 - B. Dealings in stock between shareholders. Check gains or losses to the individuals concerned where the corporation ultimately becomes involved in such transactions and consider the possibility of distributions being essentially equivalent to a taxable dividend.
 - C. Closely held companies should receive special consideration throughout the examination for such items as arm's-length failures, disguised dividends, etc.

4.35.2.5.2.5.2 (05-05-2006) New Issues of Capital Stock

1. New issues and additions during the period
 - A. Compare data obtained from the corporate minute book and charter with items recorded on books to determine if proper entries have been made.
 - B. Verify all credit entries. Give consideration to such features as: stock issued for services or properties, stock dividends, employee stock options, stock issued at less than fair market value, reorganizations, taxable and nontaxable exchanges, etc.
 - C. Determine if expenses relating to the issuance of stock have been properly handled (legal fees, registration fees, etc.).
 - D. Determine if documentary stamps have been acquired and properly affixed, and cost correctly reflected.
 - E. Determine during the examination of a recapitalization of the stock in a closely held company that the fair market value of the stock to be received by each exchanging shareholder is equal to the fair market value of the stock surrendered in the exchange. If there is a significant difference, the examiner should be alert to possible gift tax consequences.

4.35.2.5.2.5.3 (05-05-2006) Reductions and Cancellations

1. Reductions and cancellations during the period
 - A. Compare data obtained from the corporate charter and minute book with items recorded on books to determine if proper entries have been made.
 - B. Verify all debit entries. Give consideration to such features as, partial or complete redemptions, cancellations, or liquidations; write-offs; distributions essentially equivalent to dividends; etc.

4.35.2.5.2.5.4 (05-05-2006) Treasury Stock

1. If treasury stock transactions have occurred, consider such possibilities as acquisitions being essentially equivalent to dividends, etc. See IRC section 302.

4.35.2.5.2.5.5 (05-05-2006) Paid-in or Capital Surplus

1. Analyze and reconcile the surplus accounts. Verify correctness of all items, both increases and decreases, appearing on the books or return.

4.35.2.5.2.5.6 (05-05-2006) Schedule M-1

1. For C Corporations, Schedule M-1 is the reconciliation between the net income per books and the taxable income before the net operating loss deduction and special deductions. For S corporations, Schedule M-1 is the reconciliation between the net income per books and the sum of the ordinary and separately stated items of income and deductions.
2. A complete and detailed Schedule M-1 will provide an examiner with the information needed to reconcile income per books and income reported on the return. Variations can arise either because of timing differences or permanent differences between financial accounting and tax accounting. The Schedule M-1 lines are different on an 1120 versus an 1120S. These could surface in lines 4, 5, 7, or 8 of Schedule M-1.
3. Statement No. 5, *Accounting for Contingencies*, of the Financial Accounting Standards Board (March 1975), issued by the American Institute of Certified Public Accountants, defines a loss contingency as an existing condition, situation, or set of circumstances involving uncertainty as to the possible loss that will be resolved when one or more future events occur or fail to occur. An estimated loss from such a contingency shall be accrued by a charge to income if the following conditions are met: It is probable that a liability has been incurred at the date of the financial statement; and the amount of the loss can reasonably be estimated. The Standards define probable to mean that the future event or events are likely to occur. With respect to unasserted claims, litigation, and assessments, the Standards provide that an enterprise must determine the degree of probability that suit may be filed or a claim or assessment may be asserted, and the probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of the loss can be reasonably estimated, accrual of the loss is required.
4. It should be noted that the above definition is only applicable in arriving at book income. For tax, no deduction is

THE NEW TEMPORARY FEDERAL ESTATE TAX LAW

- In December 2010 President Obama signed the "Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010" (2010 Tax Relief Act) into law.

ESTATE TAX CONSEQUENCES OF THE 2010 TAX RELIEF ACT

- Scheduled to end December 31, 2012
- The old \$1 million estate tax exclusion returns January 1, 2013, with the old estate tax rates. (Assets transferred to a federally recognized spouse who is a US citizen are not now and will not be taxable after 12/31/2012.)
- Basis of assets is stepped up to the Date of Death value.
- There is still an annual per donee gift tax exclusion adjusted for inflation (currently \$13,000, \$26,000 for couples)

UNTIL DECEMBER 31, 2012 at 11:59PM

- Estate tax exclusion is now \$5 million, adjusted for inflation.
- Maximum estate tax rate is 35%.
- For estate taxes, the surviving spouse may use the remainder of the deceased spouses \$5 million estate tax exclusion.
 - Assuming the law remains unchanged, if both spouses die between January 1, 2011 and December 31, 2012 their combined estate tax exclusion can reach \$10 million with a little careful planning.
- Gift tax is subject to a \$5 million lifetime exclusion, adjusted for inflation.
- Top gift tax rate is 35%
- Generation Skipping Tax exemption, \$5 million, adjusted for inflation

NEW JERSEY ESTATE AND INHERITANCE TAX¹

- New Jersey Estate Tax, in general
 - Taxes on New Jersey Residents with estates over \$675,000
 - Taxes paid to New Jersey can be deducted on the Federal Estate Tax Return.
 - Assets passing to a spouse are not taxable.
 - Real property and tangible personal property located outside New Jersey is excluded.
 - New Jersey will fight to establish you were a New Jersey Resident at Death
- New Jersey Inheritance Tax
 - New Jersey imposes an inheritance tax on transfers to certain groups of people.
 - Exempt from inheritance tax: spouse/civil union partner, descendants, parents, grandparents, and stepchild. (Certain charitable donations are also exempt.)
 - Everyone else is subject to the New Jersey Inheritance Tax if the amount exceeds the Inheritance Tax Exemption. The exemption is either \$500 or \$25,000 depending on your relationship to the Decedent.
 - The tax rate is up to 16%.
 - New Jersey Inheritance Tax is credited to the New Jersey's Estate Tax.

¹ New York also has an estate tax.