

# Forensic Reconstruction

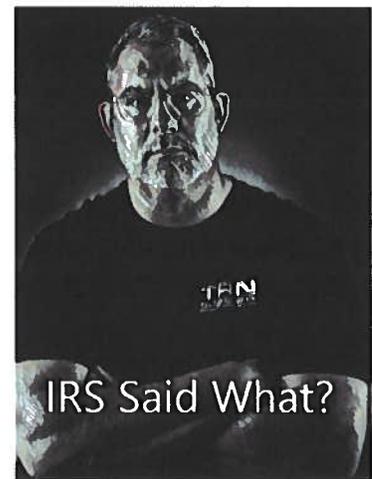
Eric L. Green, Esq.  
Dawn Brolin, CPA, CFE



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## Eric Green, Esq.

- ▶ Managing partner in Green & Sklarz LLC, a boutique tax firm with offices in Connecticut and New York.
- ▶ Focus is civil and criminal taxpayer representation before the Department of Justice Tax Division, Internal Revenue Service and state Departments of Revenue Services.
- ▶ Has served as a columnist for CCH's Journal of Practice & Procedure.
- ▶ Attorney Green is the past Chair of the Executive Committee of the Connecticut Bar Association's Tax Section.
- ▶ Eric is a Fellow of the American College of Tax Counsel ("ACTC").



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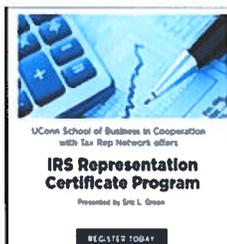
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## Eric Green, Esq.



- Eric is the host of the weekly Tax Rep Network Podcast
- Eric is the founder of Tax Rep Network, an online community designed to help tax professionals build their IRS Representation Practice
- He is the author of the Accountant's Guides in IRS Representation
- Partnered with UConn and creator of the IRS Representation Certificate Program
- Creator of the Tax Rep App

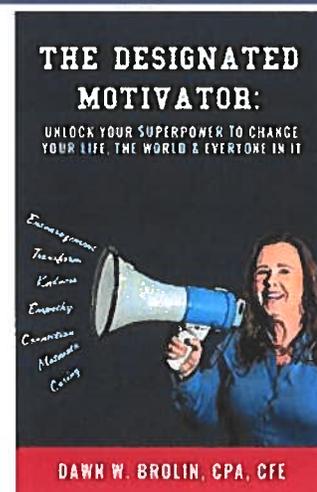


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## Dawn W. Brolin, CPA, CFE

- ▶ Dawn's contributions to the accounting profession are continually recognized with many top awards. Most recently, she was named "2020 Top Niche Practice ProAdvisor: Forensics" as well as one of the "2018, 2019, 2020, & 2021 Top 100 Most Influential People in Accounting" ~ by Accounting Today.
- ▶ Dawn recently wrote a book "The Designated Motivator for Accounting Professionals" to help accounting professionals improve the profitability & productivity in their firms. This book outlines a Reassess Your Success mindset and a tech stack that integrates and simply works.



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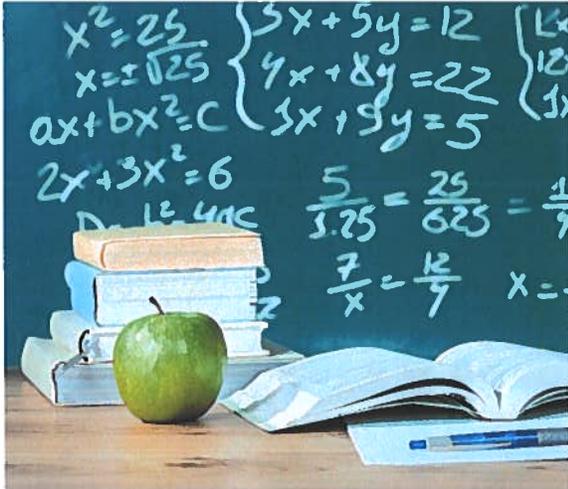
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## Learning Objectives



- ▶ A review of how non-filers are located by the IRS
- ▶ How to bring these clients in from the cold
- ▶ Where to begin when records need to be reconstructed
- ▶ How to prepare and present the information to the IRS

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TAX REP NETWORK

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## Reconstruction Technology Tools

### canopy

This transcript and practice management tool will allow you to pull transcripts for non-filers and for many other types of IRS issues and even normal filing.



Depending on the payroll solution the client was utilizing, if you have ADP, you can export their journal entries and import them into your QuickBooks file when recreating records.

### SmartVault

Storing sensitive case documents securely is absolutely critical. Per the IRS we have a responsibility to have a secure storage solution. SmartVault can be that solution for your firm!

### bookkeep

If your client uses any of the apps below, you will WANT Bookkeep to import all transactions and auto-post them accurately when recreating records.



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## Housekeeping

- ▶ 4 ce/cpe credits – 16 polls – Answer the poll
- ▶ Get the link and claim your certificate
- ▶ If you miss words you can still get partial credit but our staff will need to do this manually

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## Housekeeping

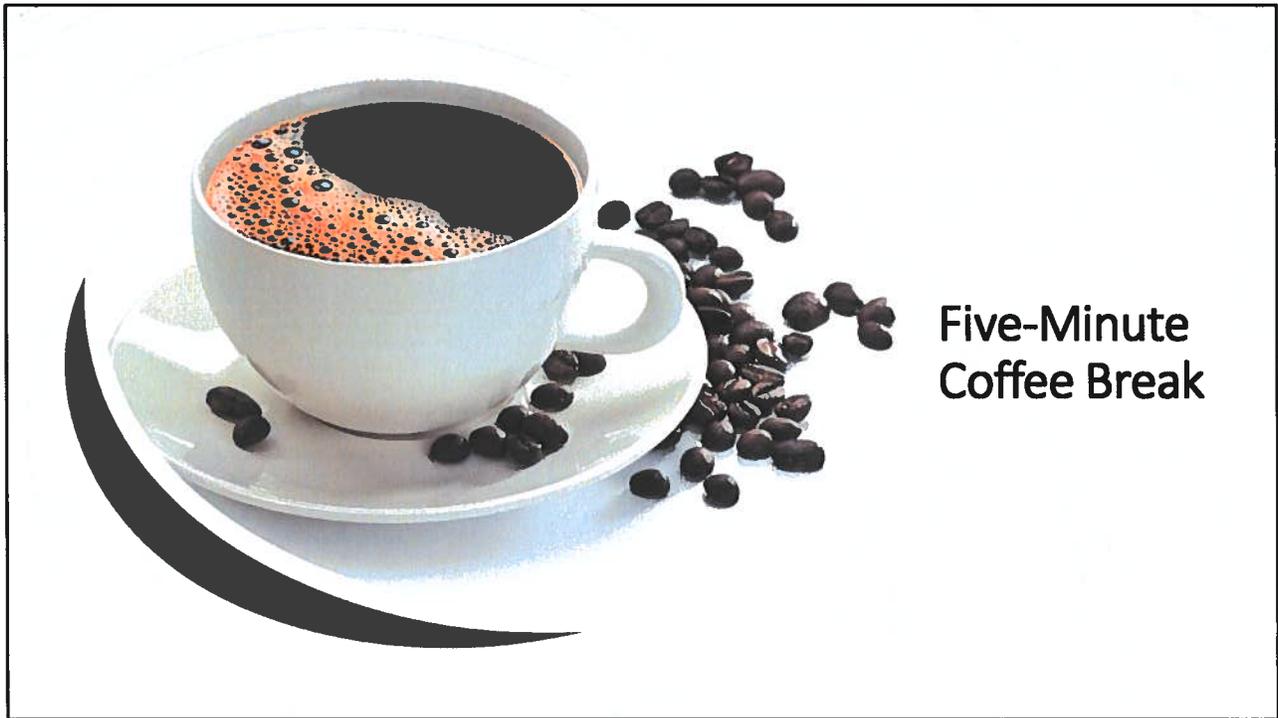
- ▶ We will take 5-minute breaks at the top of each hour after a word from our sponsor
- ▶ Stick to our schedule so you don't miss polls!



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## Five-Minute Coffee Break

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### Agenda

1. The current landscape
2. Onboarding the Client
3. Non-Filers
4. Voluntary Disclosure
5. The IRS Exam
6. Client Records
7. Hobby Loss Issues: The 9 Factors
8. Cash Businesses: Proving a Negative
9. Case Studies

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# The Current IRS Landscape

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Year	Accounts in Collection
2005	6,478,000
2006	7,074,000
2007	8,240,000
2008	9,232,000
2009	9,667,000
2010	10,391,000
2011	10,809,000
2012	11,464,000
2013	11,721,000
2014	12,410,000
2015	13,371,000
2016	14,005,000
2017	14,080,000
2018	14,386,000
2019	15,002,000

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# More Than 10 Million Non-Filers

## TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Office of Audit

### Highlights

#### HIGH-INCOME NONFILERS OWING BILLIONS OF DOLLARS ARE NOT BEING WORKED BY THE INTERNAL REVENUE SERVICE

Final Report issued on May 29, 2020

Highlights of Reference Number: 2020-30-015 to the Commissioner of Internal Revenue

#### IMPACT ON TAXPAYERS

The gross Tax Gap is the estimated difference between the amount of tax that taxpayers should pay and the amount paid voluntarily and on time. The average annual gross Tax Gap is estimated to be \$44.1 billion for Tax Years 2011 through 2013, and approximately \$39 billion (9 percent) is due to nonfilers, taxpayers who do not timely file a required tax return and timely pay the tax due for such delinquent returns. According to the IRS, high-income nonfilers, although fewer in number, contribute to the majority of the nonfiler Tax Gap.

#### WHY TIGTA DID THE AUDIT

In past audits, TIGTA identified serious lapses with the IRS's nonfiler strategy. This audit was initiated to determine whether the IRS is effectively addressing high-income nonfilers and if the new nonfiler strategy and related plans sufficiently include this segment of nonfilers.

#### WHAT TIGTA FOUND

The IRS is still in the process of conducting testing; however, the new nonfiler strategy appears to



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# Cannot Pay

**TAX** PRACTICE  
AUDIT

HOME

| INDIVIDUAL INCOME TAXES

## A Third of Americans Say They Can't Pay Their Taxes This Year Due to Covid

With record high unemployment, the TaxAudit survey shows the burden faced by taxpayers due to the crisis, with many making the difficult choice to drain savings accounts and miss mortgage payments, property tax payments, and even some monthly bills just



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# Enforcement Is Ramping Up

## Systemic Lien and Levy Programs (added June 14, 2021)

Balance due Notices are generally automatically sent to taxpayers after the tax filing deadline to those the IRS believes has a tax bill. Beginning June 15, 2021, the IRS expects to begin following up with taxpayers who failed to respond to prior notices. Taxpayers (some with 2020 and/or 2019 tax liabilities) will be notified that they have 30 days (45 if out of the country) to respond or pay their tax bills. Taxpayers who fail to respond to these additional letters could be subject to levies or Notice of Federal Tax Lien filings beginning Aug. 15, 2021.

▶ <https://www.irs.gov/newsroom/irs-operations-during-covid-19-mission-critical-functions-continue>



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# IRS Collection Process: Assessment

- The IRS will assess the tax when the return is received and processed or it creates a "substitute for return" (SFR) for the taxpayer
- Pull transcripts to determine the exact date of assessment



Certified Mail Number

5018999546711s  
JAMES Q. HINDS  
22 BOULDER STREET  
HANSON, CT 06030-7253

2D Bar Code	
Notice	3218 N
Tax Year	2020
Notice date	January 23, 2017
Social Security number	NNN-NN-NNNN
To contact us	Phone 1-866-681-4271
Hours of operation	8:00 a.m. to 8:00 p.m.
Your caller ID	123456
Last day to petition	April 22, 2017
Tax Court	
Page 1 of 8	

## Notice of Deficiency Increase in tax and notice of your right to challenge

We have determined that there is a deficiency (increase) in your 2000 income tax. You have the right to challenge this determination in the United States Tax Court. This notice explains how the increase in tax was calculated and how you can challenge it in the Tax Court. Your petition to the Tax Court must be filed by April 22, 2017.

We will still accept your 2000 tax return. Filing your return may reduce the amount due.

Summary	
Your tax liability (deficiency)	\$5,900.00
Payments you made	75.00
Failure-to-file penalty	1,339.20
Failure-to-pay penalty	606.64
Estimated tax penalty	267.33
Interest charges	808.92
<b>Amount due</b>	<b>\$8,974.09</b>

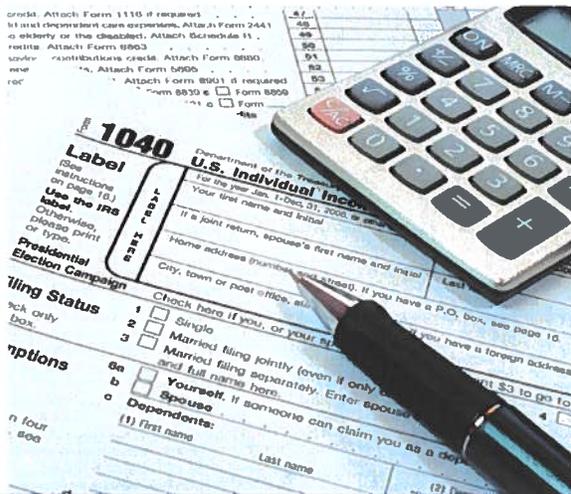


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## Goal?



- ▶ Taxpayer should voluntarily file their own return
- ▶ Otherwise IRS will do it for them

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# Onboarding the Client

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## So the Phone Rings

- ▶ Non-Filer
- ▶ Civil Audit
- ▶ Eggshell Audit
- ▶ Criminal Investigation



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## Onboarding the Client

- ▶ Retainer (docusign)
- ▶ Payment authorization (retainer)
- ▶ Kovel Letter



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## Client Onboarding Process & Technology Toolkit

- The Initial Meeting
- Client Engagement Letter & Quote for Work (covered earlier) (Quotient)
- Payment Authorization Form (DocuSign)
- Process Retainer on Account (QuickBooks Online)
- Completed Discovery Document (DocuSign)
- Provide Access for Document Exchange (SmartVault - secure storage system)
- Send List of Initial Documents Needed
- Add Client to SmartVault
- Direct Client to begin uploading documents to one folder (you sort later)
- Technology to reconstruct



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## The Initial Meeting and Information Collection



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Fax: (860) 506-6309

### IRS Civil Audit Discovery Questionnaire

This questionnaire is designed to collect information regarding your case. If a question is not applicable to this case, please type in 'N/A' as not applicable. In the space provided at the end of this questionnaire, please use that to add any other important notes that we may need to address that we haven't asked in this questionnaire. Our estimate for costs will be heavily determined by the answers in this document as well as our review of the existing accounting procedures, separation of duties as well as accounting data and supporting documents.

#### Client Information

Entity Name \_\_\_\_\_

Entity Mailing Address: \_\_\_\_\_

EIN/SSN (Employee Identification Number or Social Security #) \_\_\_\_\_

Industry Type and NAICS code \_\_\_\_\_

Primary Entity Contact Name \_\_\_\_\_

Primary Entity Contact Email \_\_\_\_\_

Primary Entity Contact Phone \_\_\_\_\_

List other individuals who will be involved in this case including their name, email and phone number

\_\_\_\_\_

\_\_\_\_\_



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# The Initial Meeting and Information Collection





CPA | TAXES | CPE | FRAUD

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Are you currently working with an attorney? (YES OR NO) \_\_\_\_\_

If so, please list their company name, the attorney's name, and contact information (in addition, you will need to notify the attorney providing permission for our firm to talk with them about your case)

Attorney Name: \_\_\_\_\_

Contact Number: \_\_\_\_\_

Email Address: \_\_\_\_\_

**IRS Civil Audit Case Description and Information**

Brief outline of your tax case including years under audit and other information:

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

**Reporting Information**

Do you have an annual audit? (YES OR NO) \_\_\_\_\_

Is your organization required to file for Sales & Use Tax? (YES OR NO) \_\_\_\_\_ Do you issue 1099's? (YES OR NO) \_\_\_\_\_

Do you have payroll? (YES OR NO)? \_\_\_\_\_ If so

How many employees? \_\_\_\_\_

Is your payroll outsourced or prepared internally? \_\_\_\_\_



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# The Initial Meeting and Information Collection





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**Accounting Software – NOTE: We will need access to the accounting software that you utilize.**

- If it is a QBO file, please invite Debra Brodin, [debra@powerfulaccounting.com](mailto:debra@powerfulaccounting.com)
- If it is a QuickBooks Desktop file and the file is in a hosting environment, instructions will follow

2. What accounting software is used?

- a. QuickBooks Enterprise
- b. QuickBooks Pro or Premier
- c. QuickBooks Online
- d. Intacct
- e. Sage
- f. Other (please provide the name and version) \_\_\_\_\_

Which letter above represents your accounting software? \_\_\_\_\_

Do you use a Hosting Environment for your accounting software? (YES OR NO) \_\_\_\_\_

How many users have access to the accounting software? \_\_\_\_\_

List names of the users, their role in the entity, and contact information:

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

**Financial Info and Internal Controls**

How many bank accounts are involved? \_\_\_\_\_

How many credit card accounts are involved? \_\_\_\_\_

Who has banking authority? \_\_\_\_\_



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# Quoting the Engagement



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# The Engagement Letter



**TEAM**  
**Brodin**  
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Fax: (860) 986-6309



DATE

CLIENT NAME AND ADDRESS

Re: Client Retention and Services Agreement

DEAR CLIENT

We are pleased you have requested that Powerful Accounting, Inc. ("PA" or "Firm") provide you with representation as set forth below. We would appreciate receiving written acknowledgement of this agreement for our files. The AICPA recommends that there be a written fee agreement between accountants and their clients. Additionally, we feel that it is in the best interest of our clients that they be fully informed of our billing practices. The purpose of this letter, therefore, is to set forth the scope of our engagement for accounting services to you, to set forth the financial arrangements regarding our engagement and to verify our agreement of the foregoing.

1. **Scope of Engagement**

Subject to the terms and conditions herein, including without limitation advance payment of the retainer and a signed copy of this agreement PA will perform those accounting, audit support, and tax analysis and preparation services which you or your legal team request (the "Engagement").

2. **Hourly Fee for Representation**

Our billing practice is to charge for our services based on the hourly rate of the staff involved. We bill in increments of no less than 15 minute increments. Please note, we bill for all services our office provides, including but not limited to correspondence, telephone calls, document preparation, physical research, electronic research, inter-office conference, meetings, etc. We use the amount of time devoted to a matter by a particular Certified Public Accountant or Enrolled Agent at that staff member's hourly rate. These hourly rates are based upon experience, expertise and standing. In addition, we try to use bookkeepers (certified and non-certified), non-certified accountants and or secretarial support on projects whenever possible. All hourly rates are reviewed from time to time and may be adjusted and/or increased without notice. In signing this agreement, you hereby consent to such increase.

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A CCH Seminar

IRS Audits

# The Engagement Letter

## 2. Hourly Fee for Representation

Our billing practice is to charge for our services based on the hourly rate of the staff involved. We bill in increments of no less than 15 minute increments. Please note, we bill for all services our office provides, including but not limited to: correspondence, telephone calls, document preparation, physical research, electronic research, inter-office conference, meetings, etc. We use the amount of time devoted to a matter by a particular Certified Public Accountant or Enrolled Agent at that staff member's hourly rate. These hourly rates are based upon experience, expertise and standing. In addition, we try to use bookkeepers (certified and non-certified), non-certified accountants and/or secretarial support on projects whenever possible. All hourly rates are reviewed from time to time and may be adjusted and/or increased without notice. In signing this agreement, you hereby consent to such increase.

Our current hourly rates are:

CPA Staff	\$375/hour
Accounting/Bookkeeping Staff	\$150/hour
Administrative Staff	\$ 75/hour



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# The Engagement Letter

## 4. Retainer

We will require a retainer of **\$0,000.00** prior to commencement of work on your behalf, the amount to be determined at that time depending upon the scope of the work you require. Should the Engagement require work beyond the anticipated scope, we may require an additional retainer be paid. If the retainer is exhausted and you receive a bill, please pay the amount due. At the conclusion of the Firm's representation of you, any remaining positive retainer balance will be returned to you. You also agree that the retainer payment may be deposited in the Company's general operating account and comingled with other funds.

Please note, we have tried to keep the retainer amount as low as possible, however, given the nature and complexity of the Engagement, it is possible that the retainer amount may be exceeded.



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# The Engagement Letter

## 6. Future Services

This agreement will also apply to services rendered for such future matters that we agree will be handled by PA. If, however, such services, are substantially different from those to which this agreement applies (for instance, ongoing accounting services), either party may request that a new agreement be executed, or that this agreement be re-acknowledged.

If this letter correctly sets forth your understanding of the scope of the services to be rendered to the company by the Firm, and if the terms of the engagement are satisfactory, please execute the enclosed copy of this letter and return it us. If the scope of the services described is incorrect or if the terms of the engagement set forth in this letter are not satisfactory to you, please let us know in writing so that we can discuss either aspect.

By executing this agreement, you acknowledge that there is uncertainty concerning the outcome of this matter and that the Firm and the undersigned Certified Public Accountant and CEO of Powerful Accounting, Inc. have made no guarantees as to the disposition of any phase of this matter. All representations and expression relative to the outcome of this matter, are only expressions of the said accountant's opinions and do not constitute guarantees. We look forward to continuing to work with you and thank you once again for the opportunity to serve.

Very truly yours,

YOUR NAME AND TITLE  
|  
READ, AGREED AND CONSENTED TO

\_\_\_\_\_  
Client Name Date

\_\_\_\_\_  
Client Name Date



# Payment Authorization



Powerful Accounting, Inc.  
188 Mullen Hill Road  
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www.powerfulaccounting.com  
Phone: (860)359-9185  
Fax: (860)386-6309

## Credit Card or ACH Authorization

I, \_\_\_\_\_, give Powerful Accounting, Inc. permission to charge my credit card, debit card, or bank account for fees associated with services performed at the time services are rendered.

### CREDIT CARD INFORMATION

Card Type (check one)	VISA ( )	MasterCard ( )	American Express ( )	Discover ( )
Credit Card Number				Expiration Date
CVV Code				
Card Holder Billing Name				
Billing Address				
City	State	Zip		
Legal Business Name				
OR				

### ACH INFORMATION

Name on Checking Account	Bank Name
Routing Number	Account Number
Bank Account Type: Checking ( )	Savings ( )



# Reconstruction Technology Tools



This transcript and practice management tool will allow you to pull transcripts for non-filers and for many other types of IRS issues and even normal filing.



Depending on the payroll solution the client was utilizing, if you have ADP, you can export journal entries and import them into your QuickBooks file when recreating records.



Depending on the case, you may want to use QuickBooks desktop or QuickBooks Online depending on the case and what other apps may need to integrate with your data file to minimize data entry and inaccuracies. You can also import banking/credit card info if you have the logins!



If your client uses any of the apps below, you will WANT Bookkeep to import all transactions and auto-post them accurately when recreating records.



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# Non-Filers



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## Step #1: Tax Compliance

- All returns filed that are due as of this date
- Current tax period payments being made
  - a) Proper withholding
  - b) Estimated tax payments
  - c) Payroll tax deposits



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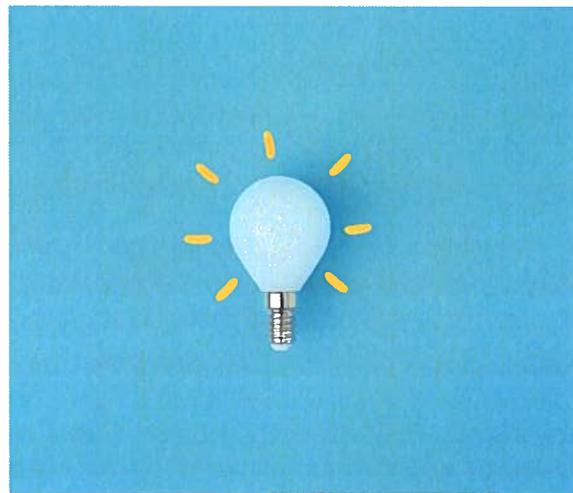


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## Inside Secret

- ▶ What is compliance for tax returns?
- ▶ Last 6 years – IRM 1.2.14.1.18
- ▶ No OIC or IA without it!



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## Prior Years? Substitute for Returns?

- ▶ Prior years do not need to do
- ▶ Can if you want to (NOLs, Cap Losses, etc)
- ▶ SFR is a return and actual return does not need to be filed (unless you want to)
- ▶ Look at State Voluntary Disclosure Programs



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## IRC § 6020

- (a) Preparation of return by Secretary – Taxpayer provides information.
- (b) Execution of return by Secretary
  - (1) Made from third party data.
  - (2) Status of returns. Any return so made and subscribed by the Secretary shall be prima facie good and sufficient for all legal purposes.



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## SFR or Summons?

- ▶ Enough 3<sup>rd</sup> party info – SFR
- ▶ If not – Summons
- ▶ RO is determined to get the return(s) filed



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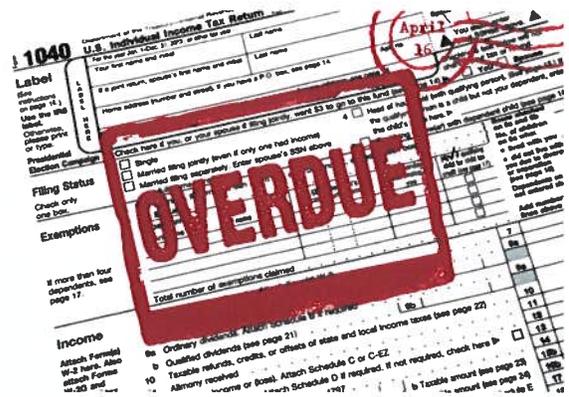


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## An SFR

- ▶ Is a tax return
- ▶ 10-Year CSED Starts
- ▶ NFTL may be filed
- ▶ Levies may be issued
- ▶ It can be paid or compromised



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# Summons

- ▶ Compel TP to provide records
- ▶ RO will put together a return for them

**Summons**

In the matter of \_\_\_\_\_  
 Internal Revenue Service (Division) \_\_\_\_\_  
 Industry/Area (name or number) \_\_\_\_\_  
 Periods \_\_\_\_\_

**The Commissioner of Internal Revenue**

To \_\_\_\_\_  
 At \_\_\_\_\_

You are hereby summoned and required to appear before an officer of the Internal Revenue Service, to give testimony and to bring with you and to produce for examination the following books, records, papers, and other data relating to the tax liability or the collection of the tax liability, or for the purpose of enforcing any other offense connected with the administration or enforcement of the internal revenue laws concerning the person identified above for the periods shown.

Do not write in this space

Business address and telephone number of IRS officer before whom you are to appear: \_\_\_\_\_  
 Place and time for appearance at \_\_\_\_\_



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# If you don't show?

- ▶ New Letter from counsel with new date
- ▶ Still no show? Then to AUSA for court order to compel

UNITED STATES DISTRICT COURT  
 SOUTHERN DISTRICT OF NEW YORK

DOC #:  
 DATE FILED: 10/24/19

UNITED STATES OF AMERICA,  
 Petitioner,  
 - against -  
 TAXPAYER, AS PRESIDENT OF  
 XYZ CORP.,  
 Respondent.

**ORDER TO SHOW CAUSE**  
 19 Misc. XXX (VLB)

**NOTICE: THIS IS A COURT ORDER WHICH REQUIRES YOU TO APPEAR IN PERSON IN ROOM 620, UNITED STATES COURTHOUSE, 300 QUARROPAS STREET, WHITE PLAINS, NEW YORK 10601, AT 10:30 A.M., ON DECEMBER 11, 2019.**

Upon the petition of the United States of America (the "Petition"), by its attorney, Geoffrey S. Brennan, United States Attorney for the Southern District of New York, together with the Declaration of Revenue Officer Alan Tebelkman (the "Declaration") of the Internal Revenue Service ("IRS"), it is hereby

**ORDERED**, that Respondent Taxpayer, as President Of XYZ Corp. ("Respondent") appear before the United States District Court for the Southern District of New York, United States Courthouse, 300 Quarropas Street, White Plains, New York, Room 620, on December 11, 2019, at 10:30 A.M., to show cause why he should not be compelled to testify and produce the books, records, and other papers demanded in the IRS summons served upon him on August 8, 2018, and annexed to the Declaration as Exhibit 1; and it is further



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TECHNOLOGY

# Voluntary Disclosure



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## 104. Voluntary Disclosure Where Are We Now by Tax Rep Network

Tax Rep Network with Eric Green

Jun 10 • 44 min



I bet you didn't know that Eric is on the subcommittee for the ABA tax section's Criminal Tax committee? Well he is joined by his committee members Laura Gavioli and John Nail to update everyone on where the IRS stands on voluntary disclosure for both domestic and foreign issues, and how best to make use of the program to save your client from their past misdeeds.

Jun 10 • 44 min

See all episodes

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## Voluntary Disclosure Overview

- ▶ A voluntary disclosure occurs when the communication is truthful, timely, and complete. The practice also requires taxpayers to:
- ▶ Cooperate with the IRS in determining their tax liability and compliance reporting requirements,
- ▶ Cooperate with the IRS in investigating any professional enablers who aided in the noncompliance,
- ▶ Submit all required returns, information returns, and reports for the disclosure period, and
- ▶ Make good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable.



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## Voluntary Disclosure Practice

- ▶ Intended only for taxpayers with criminal exposure
- ▶ Returns must be corrected for last 6 years
- ▶ Agree to a 75% civil fraud penalty on the highest balance year
- ▶ Willful FBAR penalties of 50% are the norm (see IRM 4.26.16)
  - Information return penalties are not automatic – case-by-case
- ▶ Use IRS Form 14457
  - ~ Part 1 for pre-clearance,
  - ~ Part 2 for actual disclosure once cleared within 45 days
- ▶ See IRM 9.5.11.9 (revised 9-17-20); Instructions to IRS Form 14457.



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## Submission Process

- ▶ The IRS-CI Voluntary Disclosure Practice is centralized.
- ▶ Taxpayers must provide all pertinent information using the latest version of Form 14457.
- ▶ Preclearance by IRS-CI is mandatory.
- ▶ To request preclearance, a taxpayer must submit Part I of Form 14457.
- ▶ Taxpayers are required to provide a narrative statement of facts detailing their willful conduct in Part II of Form 14457.
- ▶ Effective for all voluntary disclosures made after September 28, 2018.



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## Note: Do Not Forget the States!

- ▶ Each state has its own process
- ▶ You request to do VD FIRST, then file!
- ▶ The lookback varies widely:
  - ~ CT is 3-6 years
  - ~ NY is 3-6 years
  - ~ MA is 3 years (non-resident) or 7 years (resident)



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## Is it Timely?

- ▶ A disclosure is timely if it is received before:
- ▶ The IRS has commenced a civil examination or criminal investigation of the taxpayer or has notified the taxpayer that it intends to commence such an examination or investigation.
- ▶ The IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the taxpayer's noncompliance.
- ▶ The IRS has acquired information directly related to the noncompliance of the taxpayer from an enforcement action (e.g., search warrant, summons, grand jury subpoena).
- ▶ IRM 9.5.11.9(7) (revised 9-17-20).



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## Accelerates Disclosure of Info

- Part I – Preclearance
  - Disclosure of entities and financial institutions, among other elements
- Part II – Preliminary Acceptance
  - Detailed narrative description of the reasons for the taxpayer's non-compliance
  - Signed by taxpayer under penalty of perjury
  - Failure to provide complete narrative is disqualifying; no correction allowed
  - No assurance that narrative will not be used against taxpayer if application is rejected
    - Instructions specifically state that “[i]nformation provided to the IRS may be utilized in civil and criminal investigations.”



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## VD Special Issues

- ▶ Instructions to IRS Form 14457 provide welcome guidance on common situations:
  - ❑ Inability to pay must be disclosed in Part II, along with collection information and a payment plan
  - ❑ Joint returns where one spouse is at fault – IRS encourages a joint submission with allocation of responsibility in the narrative description
  - ❑ Estates – generally should not use voluntary disclosure unless the conduct of related parties (e.g., executors) gives rise to criminal exposure



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## The IRS Exam



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## Three Types of Exams

- ▶ Field
- ▶ Desk
- ▶ Correspondence



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## Ethical Concerns



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## Preparer Considerations

- ▶ We are not required to examine our own clients
- ▶ In general we may rely in good faith upon client provided information
- ▶ We CANNOT ignore the implications of information provided that we either know or have reason to know is inaccurate, incomplete, inconsistent, or suspect is untrue
- ▶ We are required to disclose questionable positions taken on the return – Revenue Procedure 2014-15



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## Requirement to Make Reasonable Inquiry

- ▶ The return preparer is required to make reasonable inquiries if the information furnished by the taxpayer is either questionable or appears to be inconsistent or incomplete
- ▶ Some deductions or credits require us to confirm that certain information be available before they can be claimed



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## Preparation

- ▶ IDR Items v. Everything
- ▶ Preparation is key
- ▶ Meeting the client
- ▶ Office audits



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## Preparing for the Audit



- ▶ Retained
- ▶ POA
- ▶ Discussion with the taxpayer's on intent (hobby loss concerns)
- ▶ Records

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## Preparing for the Audit

- ▶ Instructions to the taxpayer
- ▶ Do not speak to the examiner
- ▶ Do not Tweet, Facebook, or Myspace anything about the exam!
- ▶ Respond to all requests quickly



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## Preparing for the Audit

- ▶ Walk through
- ▶ Look for things that should not be there
- ▶ Explain what is there



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## Home Office Concerns

- ▶ Primary office?
- ▶ Look at it – is it solely for office use or mixed
- ▶ Measure it!
- ▶ If denied make sure the Schedule A items get back to Schedule A!



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## What About the Quickbooks File?

- ▶ IRS will seek a back-up of the Quickbooks file
- ▶ IRC Section 6001
- ▶ Regulation 1.6001-1(a) and -1(e)
- ▶ Revenue Ruling 71-20
- ▶ Revenue Procedure 98-25

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## Quickbooks - Concerns?

- ▶ More years than the exam covers
- ▶ Adjusting entries that give rise to questionable practices
- ▶ Fishing expedition?

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## Quickbooks

- ▶ Exam will want a back-up of the Quickbooks file
- ▶ They will look at adjusting entries
- ▶ Condense and make a “Period Copy” for the IRS to limit the IRS scope

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## Taxpayer Interview



- ▶ Examiner will want to interview the taxpayer
- ▶ Almost NEVER a good reason to allow the taxpayer to be interviewed!
- ▶ IRC § 7521
- ▶ Right of Consultation

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## Taxpayer Interview

- ▶ POA
- ▶ Cover all potential years, including the current
- ▶ Wage and Earning reports?



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## Documentation



- ▶ We want to be prepared for the examiner to expand the scope
- ▶ If possible, prepare for all items on the return (if an office or field exam)
- ▶ Have the client begin gathering all of the back-up from the start
- ▶ Nothing shuts down an exam faster than being prepared

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## Examiner Requests



- ▶ Respond quickly
- ▶ Review what is being turned over to the examiner
- ▶ Add explanation or obtain additional information if necessary

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# Client Records

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## Records Less than Stellar?

- ▶ Use what they have (Bank Statements, Credit Card Stmts, receipts)
- ▶ If they don't have, recreate what you can
- ▶ Remember the Cohan Rule
- ▶ Case: Cohan v. Commissioner of Internal Revenue, 39 F.2d 540 (1930)
- ▶ 433-A analysis?

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## Requirement to Maintain Records

- ▶ Taxpayers are required to maintain books and records
- ▶ When a taxpayer is audited by the IRS, the burden of proof falls on the taxpayer to support the information on his or her return.
- ▶ The United States Tax Court has ruled that the taxpayer must keep “contemporaneous” records, per Reg. § 1.6001-1.

## Requirement to Maintain Records

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## Income Reconstruction

- ▶ Generally necessary when records either no-longer exist or cannot be easily located
- ▶ Books and records are not maintained
- ▶ Books and records were destroyed by flood, fire, etc.
- ▶ Books and records are incomplete
- ▶ Generally relies on one or more of the formal indirect methods

## The Cohan Rule

- ▶ In 1918, George M. Cohan was a theatrical manager and producer doing business in partnership with a gentleman by the name of Harris.
- ▶ Cohan had originally been an actor, like his parents.
- ▶ When audited by the IRS, The IRS fixed Cohan's income as the whole of what he received from the firm of Cohan & Harris, while it lasted, and later as the whole of his own profits.



## The Cohan Rule

- ▶ In the production of his plays, Cohan was obliged to entertain actors, employees, and dramatic critics.
- ▶ He also had to travel a lot, often with his attorney. These expenses amounted to substantial sums, but he had no accounting of these expenses.
- ▶ At the trial, in 1930, Cohan estimated the amounts spent on putting on the shows.
- ▶ The IRS had refused to allow him to claim any part of this based on the grounds that it was impossible to tell how much he had spent, in the absence of any accounting records.

## The Cohan Rule

- ▶ The 2nd Circuit held that because it was obvious that Mr. Cohan had spent substantial sums on the shows, those expenses could be approximated and allowed (hence THE COHAN RULE!)
- ▶ This rule does NOT apply to those expenses that require specific documentation, such as business gifts, EITC, R&D Credits, etc.

## Methods of reconstruction

- ▶ Specific Item Method – IRM 4.10.4.2.7 (08-09-2011), Easier for a jury to understand
- ▶ Indirect Method - IRM 4.10.4.2.8 (08-09-2011), Difficult to match reported income with specific items/sources

## Formal Indirect Methods

- ▶ Used when direct comparisons of income, expenses, assets, liabilities and equity cannot be made; infers taxable income
- ▶ The formal indirect methods are audit techniques used to determine the tax liability based on the amount of unreported income.
  - IRM 4.10.4.6.3, Source and Application of Funds Method
  - IRM 4.10.4.6.4, Bank Deposit and Cash Expenditures Method
  - IRM 4.10.4.6.5, Markup Method
  - IRM 4.10.4.6.6, Unit and Volume Method
  - IRM 4.10.4.6.7, Net Worth Method

## 433-A CIS Approach

- ▶ 433-A is for collection
- ▶ Has IRS guidelines (IRS cannot really argue with that)
- ▶ Back into the income (expense analysis, really)

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## Hobby Loss Issues

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## Hobby Loss Exams

- ▶ Hobby Loss Exams are IRS examinations of taxpayer returns, usually Schedule C
- ▶ These exams add a new dimension to the exam because it is not only about income and expenses
- ▶ The taxpayer's intent will not become a central issue in the exam

## IRC § 183

- ▶ Limits deductions to the income generated by a hobby
- ▶ An activity not engaged in for profit
- ▶ Presumption of a hobby if do not generate income in 3 out of 5 years
- ▶ Horse breeding is 2 out of 7 years

Nine Relevant Factors – Treas. Regs. § 1.183-2(b)

Is The Activity is  
Conducted in a Business  
Like Manner?

The Expertise of the  
Taxpayer and/or his  
Advisors?

The Time and Effort  
Expended by the  
Taxpayer in Carrying on  
the Activity?

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Nine Relevant Factors – Treas. Regs. § 1.183-2(b)

Expectation that the  
Assets Used in the  
Activity will Increase in  
Value?

The Success of the  
Taxpayer in Carrying on  
Similar or Dissimilar  
Activities?

The Taxpayer's History  
of Income or Losses with  
the Activity?

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## Nine Relevant Factors – Treas. Regs. § 1.183-2(b)

The Amount of Occasional Profits, if Any, from the Activity?

The Financial Status of the Taxpayer?

Elements of Personal Pleasure or Recreation from the Activity?

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## The Keys to a Hobby Loss Exam



- ▶ Prepare for all the usual income and expense items
- ▶ Focus on the intent of the taxpayer
- ▶ Review the 9 factors the IRS will review

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# Cash Intensive Businesses

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## Hot Button Issue: Gross receipts

- ▶ Federal return v. Sales tax returns
- ▶ Federal return v. Bank deposits
- ▶ Federal return v. Cash register/POS system
- ▶ Federal return v. 1099s reported

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## Hot Button Issue: Expenses

- ▶ Expenses ordinary for this type of business
- ▶ Expenses are in line with industry statistics (the DIF)
- ▶ Expenses are supported by evidence of payment?
- ▶ W-2s or 1099s issued?
- ▶ Were the expenses paid/incurred during the tax year?

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## IRS Focus on Cash Businesses

- ▶ The GAO reports that much of the \$440 billion tax gap is driven by businesses who underreport their income, often due to cash transactions
- ▶ Focus is now on those individuals or businesses that deal in cash

The screenshot shows a Reuters news article. At the top left is the Reuters logo. To the right are navigation links: World, Business, Markets, and Breakingviews. Below these is the text 'U.S. MARKETS' followed by the date and time 'APRIL 13, 2021 / 11:30 AM / UPDATED 4 MONTHS AGO'. The main headline reads 'IRS chief says \$1 trillion in taxes goes uncollected every year'. Below the headline, it says 'By David Lawler' and '3 MIN READ'.

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## IRS Focus on Cash Businesses

### 3 Ways to misappropriate cash from a business

1. Skimming from receipts
2. Goods stolen for resale later
3. Fraudulent Disbursement

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## Flags for the Government

### Lessons from DOJ Prosecution of Tony Hu for Sales Tax Fraud

By [Matthew D. Lee](#) on December 6, 2016

POSTED IN CRIMINAL TAX, INTERNAL REVENUE SERVICE (IRS), IRS CRIMINAL INVESTIGATION (CI) DIVISION, MONEY LAUNDERING, SENTENCING, USDOJ TAX DIVISION



Department of the Treasury

On Oct. 18, 2016, a federal judge sentenced a well-known Chicago restaurant owner to prison for carrying out an extensive scheme to avoid paying state sales tax collected from customers of his establishments. Two

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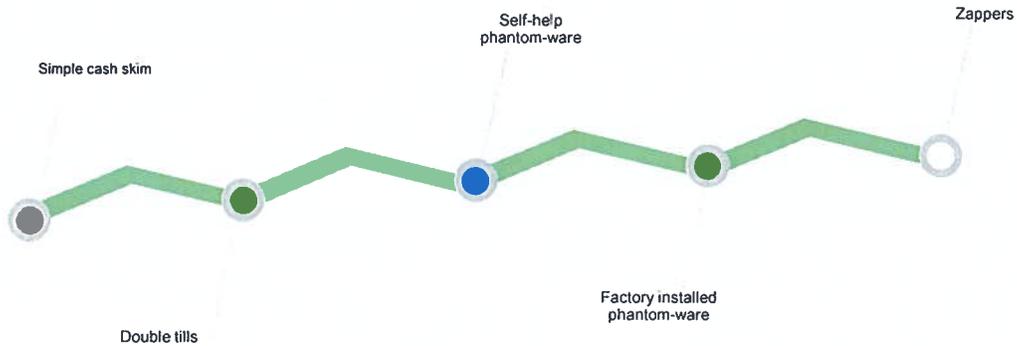
90

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# Sales Suppression

Skimming cash sales – a very old tax fraud

## The Evolution of The Skim



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This is an old Zapper that's been hard wired into the ECR.

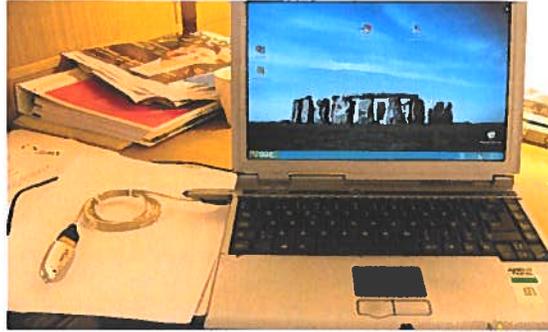


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This is a newer Zapper  
– it's a removable  
device connected to  
the PC, not the ECR.



## Indicators of Unreported Income

- ▶ Excessive lifestyle
- ▶ Business continues operating despite losses year after year
- ▶ Bank deposits or liquid investments continue to increase each year despite reporting of losses or low income
- ▶ No income reported yet debt decreases year after year
- ▶ Unusual margins or sales for the industry standard for this type of business

## IRS Focus on Cash Businesses

- ▶ Examiners are to look for income
- ▶ Expenses are generally easier – either supported or not
- ▶ Indirect methods of income analysis may be employed
- ▶ Will look at the individual owner as well – will create a burden on the taxpayer individually

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## Cash Businesses Targeted

- ▶ Bail Bonds
- ▶ Beauty Salons
- ▶ Car Washes
- ▶ Coin Operated Amusements
- ▶ Convenience Stores
- ▶ Laundromats
- ▶ Scrap Metal Dealers
- ▶ Taxicabs



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## Taxpayer Interview

- ▶ Examiner, because of the cash business, will be insistent on the taxpayer interview
- ▶ Will focus on accounting for cash receipts
- ▶ “Is all revenue properly reflected on the return as filed?”
- ▶ Will request copies of all bank accounts and then ask: “Are all bank accounts present?”
- ▶ Will focus on cash used to pay expenses as well
- ▶ Auditor knows taxpayer will be more responsive now when no issues have been raised yet

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## Use of Minimum Income Probes

- ▶ Called a “Cash-T Analysis”
- ▶ Examiner will review the expenditures
- ▶ Compare them to reported income
- ▶ Shortfall, if unexplained, is considered unreported income

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## T-Account Analysis

T-Account	
CASH RECEIVED	CASH EXPENDED
Gross Receipts (per Return)	Business Expenses (less depr.)
Gross Rents	Rental Expenses (less depr.)
Wages/Miscellaneous Income	Personal Living Expenses
Interest/Dividend Income	Purchase of Assets
Cash on Hand (at beginning)	Cash on Hand (at year end)
Cash in Bank (at beginning)	Cash in Bank (at year end)
Loans Received	Loan Payments
Nontaxable Income	
Accounts Receivable (at beginning)	Accounts Receivable (at year end)
Accounts Payable (at year end)	Accounts Payable (at beginning)
Total Cash Received	Total Cash Expended

Therefore: Total Cash Expended less Total Cash Received = Unidentified Income.

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## Bank Deposits as Unreported Income

- ▶ Bank deposits are prima facia evidence of unreported income – **Tokarski v. Commissioner**
- ▶ Burden to show the IRS determination is wrong lies with the taxpayer – **Estate of Mason v. Commissioner**
- ▶ IRS is required to consider non-taxable sources of income or non-deductible expenses – **DiLeo v. Commissioner**
- ▶ IRS is required to follow all leads reasonable susceptible of being followed that income is from non-taxable sources – **Holland v. United States**

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## Net Worth Analysis

- ▶ Assets – Liabilities = Net Worth
- ▶ Obtain a good starting net worth
- ▶ Assets at cost
- ▶ All expenses are factored in – deductible and non-deductible
- ▶ Can increases be explained by known income
- ▶ If not, assumed to be unreported income



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## Case Studies

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## Case Studies: The Clients



- ▶ The Non-Filer who died without records
- ▶ The house flipper who paid cash
- ▶ The Day Care that did not respond
- ▶ The auditors that observed for 2 hours

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## The Non-Filer Who Died Without Records



Called by the court appointed administrator



Man died in his 80s



No children



Has not filed in at least 15 years



He has \$5,000 in his back account and \$20,000 in a safe

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## The Non-Filer Who Died Without Records

- ▶ Little went through the bank
- ▶ No credit cards
- ▶ No 1099s reported in the Wage & Earning Reports
- ▶ Created a 433-A based on IRS standards and the expenses we know he spent (mortgage, utilities, etc)



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## The Non-Filer Who Died Without Records

- ▶ We used that as his income, and increased it for the \$25,000 cash hoard spread evenly over 6 years
- ▶ Prepared 6 years of federal income tax returns and 3 years of CT returns
- ▶ IRS Compliance/Vol. Disclosure is last 6 years, CT is 3 years



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## Record Reconstruction - Rules

- ▶ Cohan Rule: When the TP establishes that the TP paid or incurred deductible expenses but does not establish the amount of the deduction to which TP is entitled, TP may be entitled to estimate the amount allowable. Cohan v. Comm'r, 39 F.2d 540 (2d. Cir. 1930)
- ▶ IRC § 7491(a) shifts burden of proof to IRS when the taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the taxpayer's liability and cooperates with the audit

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## Record Reconstruction - Rules

- ▶ Are some exceptions
- ▶ Section 274 prohibits claiming the following deductions unless substantiation requirements are maintained: – Meals and entertainment – Travel – Gift Expenses – Listed Property Expenses

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## The House Flipper Who Paid Cash

- ▶ Exactly what the title says
- ▶ Received audit notice
- ▶ Reconstructed costs by before and after photos and searching Lowes and Home Depot online for prices
- ▶ Save as much of the expenses as possible
- ▶ IRS cannot give you zero when it is obvious you spent money (except or those expenses where documentation is required)



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## The Daycare that Did Not Respond

- ▶ Daycare owner had a stroke
- ▶ Audit notice was not responded to
- ▶ Auditor took an industry standard (day cares get 30% of their payments by credit card)
- ▶ Took 1099-K, assumed it was 30% and came up with \$2 million in unreported cash
- ▶ 75% civil fraud penalty and interest



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## The Daycare that Did Not Respond

- ▶ Daycares are licensed by the state – certain number of children
- ▶ Town has prints and layouts of the building
- ▶ Provided above plus proof of payments
- ▶ This day care is in an extremely wealthy area so parents just leave credit cards on file for monthly charging
- ▶ Appeals agreed to a no-change



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## The Pizza Shop Observation

- ▶ Shop open 6:00 am – 11:00 pm
- ▶ Audited
- ▶ Auditor shows up at 8:00 am and leaves at 11:00 am
- ▶ Comes up with 90% cash
- ▶ Projects this vs 1099-K and comes up with \$300,000 if income tax due with penalties and interest



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## The Pizza Shop Observation

- ▶ Morning is bagels, newspapers, coffee (Cash)
- ▶ Lunch is slices, sandwiches, sodas (mix of cash and credit)
- ▶ Night is pizzas, salads, dinner platters, beer and wine (almost entirely credit)
- ▶ The vast majority of the dollars in are credit
- ▶ Observations are great but the auditor must observe the ENTIRE TIME, otherwise it is skewed
- ▶ Appeals reduced the liability to \$8,900, no penalty



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## A Comment on Industry Standards

- ▶ Helpful, but
- ▶ Must be up to date
- ▶ Technology is changing everything
- ▶ Cash businesses are not really anymore (cabs/uber/lyft, Pizza/slice, arcades/laundromats now have credit cards, etc)



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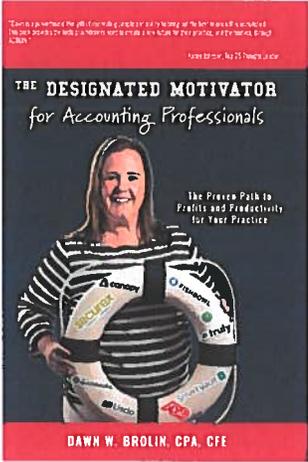
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## Questions?



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