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FINANCIAL STATUS AUDITS

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After a legislative prohibition against financial status audits, IRS has issued a field service advice[1] (the Advice) that allows a revenue agent to drive by a taxpayer's house and to conduct a Lexis search to determine if the taxpayer purchased real estate prior to having a reasonable indication that there is a likelihood of unreported income. The field service advice concludes that such actions are methods used to determine the likelihood of underreported income and are not prohibited by section 7602(e). Accordingly, either method may be used to determine if there is a reasonable likelihood of unreported income which would then require the use of an indirect method.[2] The reasoning behind the Advice requires an understanding of the current standards for an examination of income by the IRS. In addition, this column discusses both indirect and direct methods of determining income**.**

Background

The IRS is caught between a rock and a hard place. On the one hand, IRS is charged with requiring that taxpayers comply with the Internal Revenue Code by reporting all reportable income. On the other hand, their techniques have often been viewed as too heavy-handed when law-abiding taxpayers have come under excess scrutiny. The challenge seems to be to continue using appropriate audit techniques while not overstepping reasonable thresholds of behavior with invasive techniques.

The Tax Gap

The need for audit techniques to detect unreported income is well documented. Various reports were made to Congress while it was considering legislation that resulted in IRS Restructuring and Reform Act of 1998.[3] For example, in his comments to the National Commission on Restructuring the IRS,[4] the IRS Compliance Research Director indicated that the gross tax gap, the amount of tax liability that is not paid voluntarily and timely, exceeded $173.8 billion for 1992, the most recently issued update of the gap at the time. This estimate included $95.3 billion of individual income tax liability, $33.1 billion of corporate income tax liability, and $39.0 billion of employment tax liability.

AICPA Letter – Concerns involving financial status audit techniques

In a 1996 letter to the IRS, written in response to an IRS memorandum, representatives of the

[1] IRS National Office Field Service Advice (October, 2000), "Financial Status Audits."

[2] id page 4.

[3] PL105-206, 7/22/98.

[4] Statement of Wayne Thomas, National Director of Compliance Research, on the Tax Gap, before the National Commission on Restructuring the IRS, January 9, 1997.

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