

CPA CSI: Creatively Searching for Income

As Published in *Memphis Business Journal*, February 2004

By Robert Vance, CPA, CVA, CFP

Why would anyone have a need for Creatively Searching for Income on a tax return? Everyone is always honest and straightforward in a business acquisition, loan application, divorce or lost profits lawsuit – aren't they? Forensic CPA work may not be as exciting as watching the team on *Crime Scene Investigation* solve a murder, but we can often find the missing piece of the puzzle that solidifies your decision-making process or proves your case. The forensic CPA can assist the buyer, seller or litigant in proving or disproving the existence of income, validating claims of separate property, determining disposable income, verifying the standard of living and identifying transmuted property.

This article will focus on techniques used by forensic CPAs to identifying income using the form 1040, U.S. Individual Income Tax Return as the starting point. The 1040, however, is not always a completely accurate reflection of a subject's true income. The individual may legitimately report a lesser amount of taxable income and draw a considerably larger amount of cash than that reported. I have used the following tax return *CSI* methods on many forensic engagements, but they can be used by anyone trying to make sense of facts and figures in common business and litigation situations.

Start with the basics on the form 1040

The starting point for most forensic investigations involving individuals begins with reviewing several years of the 1040 in order to gauge the level and consistency of income and deductions. Income miraculously tends to fall in the periods preceding an event like a divorce, and income tends to rise in those preceding a business sale or major loan application.

Form W-2 Examine the Line 1 "Wages" and Line 5 "Medicare Wages" for a difference. Observe the box 13 check boxes for "Retirement Plan." If this box is checked or a difference exists between Lines 1 and 5, then the employee probably has a retirement or 401(k) plan or other salary reduction benefit. State income taxes withheld in excess of 6-8%, or by a person who does not live or work in that state, or federal income taxes withheld in a larger percentage than the tax bracket the person would likely fall within, may indicate this person is intentionally overwithholding and parking funds to hide from the lawsuit. Another related hiding technique involves overpaying estimated taxes, which is reported on the second page of the 1040. This transgression is not obvious and would require direct information from the IRS or examination of bank records.

You should not always necessarily assume that the W-2 is prepared correctly since many errors and omissions occur on them. I have been told many times that a divorcing spouse is "in cahoots" with the business owner, or the subject prepares the W-2s himself. Try to obtain corroborating information like a paystub or payroll summary from the employer if the information seems suspect.

Schedule A (Itemized Deductions) An astute individual can hide assets (cash) in prepayments for his future benefit. These prepayments can often be detected on Schedule A. Analyze the property taxes that should be due annually to see if substantially more is deducted than in the past. Prepayment of a year or two of taxes can add up. Perform the same check on mortgage interest. An increase in interest deduction from one year to the next could indicate prepayment of a

few mortgage payments, and, conversely, a large decrease in deduction could indicate a refinancing or large principal pay-down. Payments of an unusual or extraordinary nature can usually be found by examining the bank records, but can often be lost in the maze of bank accounts or check volume.

Schedule B (Interest and Dividends) If interest and dividends are reported, then an investment asset is generating the income. If the person owns growth stocks or other non-dividend producing assets, then little or no income will be reported. Although nontaxable municipal interest is supposed to be reported, many filers omit this since tax-exempt income is not reported to the IRS. Be aware that assets may be transferred to a child through an UGMA, to another person by “gift”, to a trust or to a corporation. The IRS reporting is on that other entity’s SSN or EIN, thus disguised.

Schedule C (Sole Proprietorship) A sole proprietor does not have to keep a balanced, double-entry accounting system, i.e., many owners keep their records in a coffee-stained spiral notebook. Since the income statement and balance sheet are not required to be reported and reconciled together on the return, as is the case with a corporation, partnership or LLC, manipulation can occur. Most Schedules C are reported on the cash basis, thus receivables and inventory may exist but are not recorded anywhere. If possible, inspect sales tax returns, customer invoices or cash register tapes to ensure that all income is reported and not pocketed. Watch for excessive vehicle, travel, meals and miscellaneous expenses. Depreciation can be manipulated legitimately for tax reporting by writing off the full value of assets under IRC Sec. 179 and other newer expensing provisions. These artificially high depreciation deductions allow write-offs that distort the true income picture of a business.

Schedule E, (Rental, Partnership/LLC and S Corporation) A common, legitimate tax dodge allows small business owners to pay themselves rent for buildings they own in lieu of a larger salary or draw. The rent expense is deducted on the business return, but the reportable income is sometimes mysteriously absent on the individual’s 1040 rental income Schedule E, thus tracing is required.

Profit or loss for a partner, LLC member or S corporation owner is reported to them in the form of a Schedule K-1, which is an attachment to a business tax return. A partner or LLC member should not receive a W-2 to report his income since he is not a legal employee, and an S corporation owner should receive a W-2. When inspecting the partnership/LLC and S corporation income section on page 2 of Schedule E, scrutinize the income/loss reported. This does not necessarily reflect the actual income received by this owner. An S corporation owner will commonly take compensation in the form of “S corporation draws”, which is essentially a non-reported return of capital likened to a dividend, in place of or in addition to his W-2. If the K-1 is correct, the draw figure will appear on the second page. If not reported there, check the corporate tax return balance sheet on page 4 for the distributions. In a recent divorce case, I observed an owner’s S corporation K-1 that reported income of \$49,250. The owner took no W-2, but rather took all of his compensation, \$78,500, as an S corporation draw (which is against IRS rulings because it avoids payroll taxes). The K-1 was in error and did not report this draw, but found it on the corporate tax return.

The partner/LLC member receives most of his compensation by taking draws, not “payroll” per se. The draws should be reported on the K-1 and on the business return, form 1065, page 4. Be aware that both LLCs and partnerships file on form 1065, the partnership tax return. Another form of compensation, likened to a salary, is called a “guaranteed payment” and should be re-

ported on that partner's/member's K-1. A common error (or deception) is the failure to report the guaranteed payment (salary) on the K-1 and bypass paying tax on it. Once again, income reported on the K-1 does not necessarily reflect the owner's actual income received.

Another aspect to consider is the amount of capital or loans a small business owner may invest in or loan to his company, thus parking cash out of the way of prying eyes. Owners can easily bury capital on a tax return. Track the retained earnings or partners equity from year to year. The basic formula is beginning (prior year) balance plus net income earned less draws equals ending balance. Analyze the total capital and owner-related loans. If these balances seem high for the type of business, ask yourself if this business needs a large amount of accumulated capital to operate.

Forensic Techniques After the Tax Returns Autopsy

Dead men don't talk, and sometimes tax returns don't either. Forensic CPAs will often be called upon to conduct an "autopsy" to determine the cause of discrepancy in income claimed versus reality. Assuming no personal or business financial statements are available and the tax returns are silent, then where do you look? Five basic methods are available to prove unreported income: the Transaction Method, Net Worth Method, Expenditures Method, Bank Deposit Method and Percentage Method.

Transaction Method This is the easiest method to employ since it involves identifying a specific item or transaction that was not properly reported on a tax return such as a real estate sale or securities sale. Most financial transactions and earnings are reported to the IRS on some type of form, like a 1099. An individual may fail to identify to the court or report on the tax return items that are recorded on a 1099-S, from a real estate sale, or 1099-B, from a broker sale of securities. This is discussed as a general concept above in relation to erroneous K-1 reporting. A business might also inflate inventory values or create fictitious payables in order to depress reportable income. In this case, a thorough fraud audit may need to be conducted on the business' books.

Net Worth Method Many civil and criminal tax cases use this method to determine unreported income and to support findings from other methods employed. The concept is simple - if an individual's net worth from one year to the next increases beyond the reported income, then unreported income probably exists. Outside of a form 1040, records of assets can be obtained from county assessors, bank and brokerage accounts, federal estate and gift tax returns and loan/credit card applications. After an unsubstantiated increase in net worth is established, a likely source for this income must be determined other than from accumulated cash, loans, inheritances, gifts, insurance proceeds, etc. If the individual claims the likely source was from accumulated cash, you need to establish the unreasonableness of this by searching for checks returned for insufficient funds, bankrupt filings, offers in compromise or installment agreements with the IRS, Social Security and employer records showing low income, deposition answers about cash on hand, etc.

Expenditures Method This method is very simple to understand and apply and is useful when the individual spends most of his income and does not save much. Establish annual expenses through affidavits, checkbooks, bank statements, canceled checks, etc. If the expenses exceed the reported income and it can be established that the gap was not bridged with accumulated cash, loans, inheritances, gifts or insurance proceeds, you probably have found unreported income.

Bank Deposits Method The IRS commonly uses this method to catch tax cheats. All deposits recorded in all banks and other institutions are totaled, cash received by the individual that was not deposited and used to pay expenses is added, deposits that do not represent already reported

and known taxable income are subtracted and business expenses paid by check or cash are subtracted. Finally, the standard or itemized deductions and exemptions, as reported in the 1040, are deducted to arrive at taxable income. If more taxable income is found with this formula than was reported on the 1040, the individual probably has unreported income.

Percentage Method Not used as often, but this is a good method for supporting findings from other methods when investigating a business. An established and reliable profit percentage, typical of that business, is multiplied by a reported income base, such as sales or gross profit, to determine net income. The formula net income is compared to that reported on tax returns or financial statements to establish an underreporting of income.

I used a variation of this method combined with the business valuation method of capitalized returns a few years ago in a divorce. The case involved a family that owned the local cable company and several other businesses in the small town. The husband owned a separate property minority share of the businesses and had successfully stalled producing financial statements and tax returns, but we did have all of the 1040s for the duration of the marriage. The attorney that employed me had been assigned this case a few days before trial and needed me to very quickly establish an increase in value of the separate property since an antinuptial agreement was signed. I established a value of the businesses in each year of the marriage by taking his minority reported income on the 1040s and “grossing it up” to a full value using his ownership percentage and a reasonable rate of return. This gross up provided me with a figure for goodwill, which I added to the “hard assets” he had reported on an affidavit. Together, the goodwill and hard assets established a value that the wife was able to show had increased substantially during the marriage. The judge approved the easy-to-understand methodology and awarded a decent property settlement, despite the antinuptial agreement.

Conclusion Hiding income and assets is routine and seemingly easy for a litigant. The transfer of income between an individual’s 1040 and his business return, and visa versa, is easily manipulated and can go undetected without the proper scrutiny. Tax returns are often the first, best shot at **Creatively Searching for Income**, so hire an experienced CPA to read between the lines and keep an eye on the cash flow. Forensic accounting isn’t flashy and fancy, but it is often as important to a lawsuit as the *CSI* team is to a murder investigation.