

Revenue Administration: Taxpayer Audit— Use of Indirect Methods

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TECHNICAL NOTES AND MANUALS

Revenue Administration: Taxpayer Audit— Use of Indirect Methods

Edmund Biber

This technical note addresses the following questions:

- Why do tax administrations need to use indirect audit methods?
- What indirect audit methods are commonly used by tax administrations?
- What are the legislative requirements for the use of indirect audit methods?
- In what circumstances is it appropriate to use indirect audit methods?
- What is required to withstand challenges to indirect audit methods?

I. Why do tax administrations need to use indirect methods?

A taxpayer audit program must embrace a range of methods and techniques for determining and verifying a taxpayer's income if it is to be an effective component of a balanced compliance management strategy. Detecting and deterring non-compliance requires more than a mere examination of a taxpayer's books and records and necessitates an analysis of the taxpayer's financial affairs to correctly assess tax liabilities.

Direct methods, often referred to as specific issue or specific item methods, rely upon verification of income or expenses by direct reference to the books and records used to prepare the tax declaration. Adjustments to declarations or assessments are supported by specific evidence in relation to an income or expense item.

Indirect methods involve the determination of tax liabilities through an analysis of a taxpayer's financial affairs utilizing information from a range of sources beyond the taxpayer's declaration and formal books and records. Assessments are often based on circumstantial evidence indicating a reasonable estimate of the taxpayer's correct liability.

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Auditors in many administrations only check that a taxpayer's declaration reflects the figures in their books of account. However, if tax administrations rely solely upon taxpayer declarations, business records, and books of account to determine tax liability, taxpayers could limit their liability by creating records that do not truly reflect their financial position, or by merely opting not to maintain books and records and not filing tax declarations, avoid a tax assessment. Therefore, indirect methods have been developed to assist auditors in objectively determining tax liabilities when the books and records are either unavailable or do not adequately reflect the taxpayer's financial affairs. Indirect methods of income measurement can also be valuable in risk assessment and testing the veracity of taxpayer claims.

II. What indirect methods are commonly used by tax administrations?

Tax administrations have developed a range of formal indirect income measurement methods to consistently and efficiently deduce a reasonable estimate of income to demonstrate under reporting when declarations and books and records cannot be relied upon. Although some administrations will vary terminology and modify approaches and techniques, the methods commonly adopted and their respective usefulness are outlined below. This paper does not attempt to provide detailed tuition in the application of indirect methods, however further guidance in the use of common indirect methods, together with examples of computation, is available in the IRS Internal Revenue Manual¹ through the IRS public website.²

Bank deposits and cash expenditure method is based on the premise that money received must either be deposited or spent. This approach is particularly useful if an analysis of bank accounts and a taxpayer's cash expenditure indicates a likelihood of undeclared income and the taxpayer makes regular payments into bank accounts that appear to be from a taxable source.

A detailed analysis of all **bank deposits** into business and personal accounts, loan accounts, and accounts held with credit unions, investment trusts, and other financial institutions, that may be maintained or controlled by the taxpayer, provides the auditor with a figure for total deposits. Non-taxable receipts, for example loans, gifts, inheritances, are then deducted where the taxpayer is able to provide evidence of such receipts, giving the auditor a net receipts deposited figure.

To establish receipts that were not deposited, **cash expenditures** need to be accounted for. Business expenses claimed in the declaration but not paid out of bank accounts are taken to have been paid by cash. Cash purchases of capital items and cash loan repayments, both personal and business, personal expenses paid with cash, and increases in cash on hand need to be determined through a thorough analysis of the taxpayer's financial affairs. Any non-taxable cash, for example, loans, withdrawals from accounts, or gifts that are used to make above payments, where substantiated by the taxpayer, are deducted to ascertain taxable gross receipts.

¹Internal Revenue Manual – Formal Indirect Methods of Determining Income, Chapter 4.10.4.6

²www.irs.gov/irm/part4/irm

For taxpayers using an **accrual basis of accounting**, the above computation of gross receipts is adjusted for movements in accounts receivable and accounts payable and then compared to the gross receipts reported in the taxpayer's declaration to calculate the adjustment to income. As expenses claimed in the declaration, but not paid out of the bank account, are included in cash payments, an adjustment will represent overstatement of deductible expenses or understatement of income.

As with most indirect methods, the burden is on the taxpayer to prove that receipts came from a non-taxable source. However, the auditor should endeavor to establish a likely source of the income or negate the taxpayer's contentions as to the non-taxable sources. During examination of all bank deposits and cash disbursements the auditor is likely to uncover leads as to the source of unreported income that will support assertions as to the likely source of the income. On the basis that all income must be either deposited or spent, accurate execution of this methodology provides a strong case for adjusting or establishing the veracity of declared income. Non cash items such as depreciation need to be considered separately as specific item adjustments.

Source and application of funds method, also often referred to as the **excess expenditure method**, the **T-account method**, or a **funds statement**, is based on the theory that if expenditure exceeds declared income plus income from unreported sources in a given tax period, that excess expenditure represents undeclared income from taxable sources. That is, funds applied cannot exceed funds available unless there are undisclosed sources of income.

Although the method requires a detailed analysis of all funds (taxable and non-taxable) available to a taxpayer, all expenditure (business deductible and non-deductible and private), increases and decreases in assets and liabilities, and adjustments to account for deductions not involving application of funds (e.g. depreciation), it is a favored approach when it is clear that the taxpayer's declared income could not sustain the evident wealth, expenditure, or lifestyle of the taxpayer.

Sources of funds are represented by the taxpayers declared income and income from non-taxable sources which the taxpayer is able to substantiate (e.g. gifts), decreases in assets

(e.g. bank account balance or accounts receivable), and increases in liabilities (e.g. principal amount of loans or accounts payable).

Applications of funds include increases in assets (business and personal), purchases, business expenses, personal living expenses, and decreases in liabilities.

Box 1. Formula for using bank deposits and cash expenditure method

Total deposits (including business and personal accounts)

Add Cash expenditure (cash payments for business, capital, and private expenses)

Add Increase in cash on hand

Less Nontaxable receipts (e.g. VAT or sales tax, transfers between accounts, loans)

Equals Gross receipts as corrected

Less Gross receipts as per declaration

Equals Understated income

Box 2. Formula for computing income by source and application of funds method.

Application of funds

Asset Increases
Liability decreases
Deductible expenditure per declaration
Non deductible expenditure

Less

Sources of funds

Asset decreases
Liability increases
Non taxable income
Declared income

Equals Understatement of income or overstatement of deductible expenditure

If income has been correctly declared and the auditor has accurately reconstructed the taxpayer's financial affairs using the source and application of funds method, the T-account will balance, that is, the source of funds will equal the application of funds. However, if the application of funds figure is greater than the source of funds, it is concluded that the excess expenditure represents an understatement of income, or overstatement of deductible expenditure, and unless the taxpayer can prove that income was derived from a non-taxable source, the taxpayer's declaration of income is adjusted accordingly.

Net worth method, also known as an **asset betterment** or **asset accretion method**, assumes that increases in net assets, after adjustments for non-deductible expenditure and non-taxable income, represent taxable income. As it is also based on the

theory that funds applied or expended cannot exceed funds available, the analysis required is similar to that used in the source and application of funds method, however it extends over a number of years or tax periods to ascertain changes to net worth from one year to the next.

The method relies upon a thorough analysis of all assets, liabilities, expenditure (business and private), and non-taxable sources of funds to reconstruct a taxpayer's financial affairs over a number of years. For this reason, it is more commonly used in cases where the taxpayer is suspected to have avoided tax and accumulated considerable assets or had substantial changes in net worth over some period of time.

Box 3. Formula for computing income by the net worth method.

(a) Assets less liabilities = net worth

(b) Net worth at end of year

Less: Net worth at beginning of year

Equals Increase or decrease in net worth

Add: Nondeductible expenditure

Less: Nontaxable income

Equals Aggregate annual income as corrected.

As the formula below illustrates, the taxpayer's net worth (total assets less total liabilities) is determined at the beginning and at the end of the taxable year. The difference between these two amounts will be the increase or decrease in net worth. Adjustments are then made for non-deductible and non-taxable items to arrive at taxable income. Declared taxable income is then compared with income computed to determine whether income was understated, or if there was no declaration, the calculation determines the amount of taxable income.

Percentage mark-up method relies upon applying a dependable ratio to a known base figure to

establish a taxpayer's gross receipts. For example, a taxpayer's customs declaration or a supplier's record, shows the cost of a unit to be \$100 and if the auditor has evidence that the taxpayer is selling the units for \$175, then the auditor can apply a 75 percent mark up to the cost of goods to establish a gross receipts figure. In reverse, a **mark-down** methodology may be adopted to establish cost of goods sold when the sales figure is the known factor and it is suspected that the purchase claim has been inflated. These methods are particularly useful in indirect tax audits when it is necessary to establish the value of inputs or outputs, and is also valuable in income tax audits as it focuses on establishing either the sales or purchases figure rather than reconstructing the taxpayer's financial affairs as necessary in methods described above.

The strength of the method will depend upon the reliability of the percentage figures used in computations. Although industry standards and references to similar businesses or situations may provide a good guide as to the mark-ups used, even if the taxpayer's accounts are incomplete, an analysis of subsidiary records will often provide a better indication of actual margins adopted in that taxpayer's business. For instance, gross profit percentages may be determined by comparing purchase invoices to sales invoices, analyzing price lists, examination of inventory records,

order books, shelf prices, and other similar data. If it can be proven that the taxpayer consistently applies the same margin, particularly applicable to retailers of a limited range of goods, it will be difficult for the taxpayer to refute computations based on this methodology.

Unit and volume method provides for the determination or verification of gross receipts by applying price and profit figures to the known or ascertainable volume of business done by the taxpayer. This method is feasible when the auditor can ascertain the number of units handled by the taxpayer and also knows the price or profit charged per unit. The number of units or volume of business done by the taxpayer may be determined in certain circumstances from the taxpayer's books, as the records may be adequate as to purchases or expenses, but only inadequate as to sales. In other cases the determination of units or volume handled may come from third party sources or subsidiary records.

Using analytical and investigative techniques and accessing subsidiary records an auditor will often be able to ascertain the number of units of production or volume of work performed that

Box 4. Example of Percentage mark-up method to determine gross receipts.

Bar

Cost of liquor			
200,000			
Cost of beer			150,000
Cost of food			<u>50,000</u>
Cost of Sales—Liquor (% of selling price)	33 $\frac{1}{3}$ %		
Cost of Sales—Beer (% of selling price)	66 $\frac{2}{3}$ %		
Cost of Sales—Food (% of selling price)	50%		
Sale of liquor			600,000
Sale of beer			225,000
Sale of food			<u>100,000</u>
Total Sales as computed			<u>925,000</u>

will allow an extrapolation of a sales figure. There may be a regulatory agency or government agency to which the taxpayer reports units of production or service or payroll figures. There may be instances where the royalty paid for leasing machinery is based upon the units of production. A piecework system of wages for production workers might also give an accurate measure of units produced. Examination of subsidiary records and establishing the relationship between inputs and outputs, for example: loaves of bread from a quantity of flour; number of glasses of liquor sold from one bottle or keg; amount of water used per wash in a commercial laundry; number of sheets laundered to the number of rooms occupied in a hotel per night; number of subscribers to a magazine; number of customers in an appointment book; or order books for component parts required to manufacture saleable products; often enables a reasonably accurate estimate of volume of sales and applying a reliable sales price to the volume will provide the auditor with a gross sales figure. As well as piecing together information from taxpayer's records, data on volumes supplied to or purchased from the taxpayer may be obtained from third parties.

The use of this method lends itself to those businesses in which only a few types of items are handled or there is little variation in the type of service performed. If the auditor can determine

the volume of inputs or outputs handled by the taxpayer and can establish the price of a unit or profit per unit, the method will provide a reasonably accurate assessment of taxpayer's income without the complexity of totally reconstructing the taxpayer's financial affairs. The method can be used for determination of gross receipts in the calculation of both indirect and direct tax liabilities.

Box 5. Example: Unit and Volume Method

Average sales price per item	1,000
Number of items manufactured	<u>920</u>
<i>Equals:</i> Total sales per unit & volume method	920,000
<i>Less:</i> Sales reported by manufacturer	<u>800,000</u>
<i>Equals:</i> Omitted sales	120,000

Industry benchmarks, business standards, and profiles can be useful tools to ascertain the reasonableness of a taxpayer's declaration, for use in risk assessment and in negotiations with taxpayers. They are used on the basis of the principle that businesses of comparable size and nature should have similar financial performance. However, as they represent averages of business operating performance for a group of taxpayers and may not reflect a specific taxpayer's circumstances, they will not always be considered sufficient evidence of an understatement of income in a court of law and are therefore not always included in listings of "formal" indirect methods.

Nonetheless, more and more administrations are finding the development of benchmarks for small businesses to be a valuable tool for risk assessment and also to inform taxpayers of expectations of business performance in their particular industry. Use of standards is also formally accommodated by legislation in some jurisdictions. Using the benchmarks will, at the very least, assist the auditor in planning the audit and determining whether the taxpayer's figures are reasonable or whether there is a need to undertake further work to establish evidence of understatements.

Using declaration data, the Australian Taxation Office (ATO) has developed and published³ industry **performance benchmarks** providing a range of ratios for: (1) cost of goods sold to turnover; (2) labor to turnover; (3) rent to turnover; (4) GST-free sales to turnover; and (5) motor vehicle expenses to turnover; to indicate average business performance for small businesses in certain industries.⁴ Additionally **input benchmarks** have been developed showing an expected range of income for trades' people working with domestic customers based on labor and materials they use. Tax administrations in other countries, e.g. Germany, New Zealand, United States, and United Kingdom, have also developed industry standards and business profiles to aid audit staff in the examination of taxpayers' affairs⁵

Legislation in Finland⁶ specifically provides for estimates based on comparisons with taxpayers in similar businesses under comparable conditions where there is suspicion of hidden income. Courts in other jurisdictions have supported the use of statistical data and industry averages to raise assessments.⁷ Recognizing that industry standards are not always an accurate measure of income, the revenue code in the United States places the burden of proof on the administration with respect to income reconstructed solely through the use of statistical information on unrelated parties.⁸ The auditor must therefore provide other supporting evidence for the computation of understatements of income.

Industry standards not only serve auditors in gauging the extent of potential evasion, but also provide tax administrators with a tool for identifying high risk taxpayers and encouraging self regulation. Alerting taxpayers to relevant standards will often persuade them to review their records and where appropriate revise their declarations, thereby alleviating the need for costly audits. Auditors also find using standards relating to personal living expenses assists in establishing a base for such expenses when undertaking audits using net worth, cash expenditure, or source and application of funds methods.

Leads from third parties can also provide a basis of detecting undeclared income. Financial institutions, government agencies, stock exchanges and brokers, trade suppliers, real estate agents, and sales agents, can provide a wealth of information that may indicate evasion, assist in the computation of undeclared income by using the above indirect methods, or may provide direct evidence of amounts of undisclosed income. Increasingly, administrations are automating their interaction with such institutions, automatically capturing such information and matching the data with

³Understanding and using small business benchmarks—www.ato.gov.au

⁴Including, manufacturing, construction, retail trade, accommodation and food services, transport, and warehousing, rental hiring and real estate services.

⁵Refer to survey responses published in OECD Information Note on Strengthening Tax Audit Capabilities: Innovative Approaches to Improve the Efficiency and Effectiveness of Indirect Income Measurement Methods, October 2006.

⁶Act on Assessment Procedure sections 27 and 30

⁷Privy Council in *Gamini Bus Co Ltd V Comm. Of Income Tax*, Colombo (1952) TR 44; U.K. - *Coy v Kime* 59TC447; Australia - *Case B1 2TBRD* (1951), and *Favaro v. FCT* (1996) 34 ATR 1.

⁸IRC section 7491(b)

taxpayer declarations. This practice also provides auditors with ready access to relevant information through internal databases rather than having to undertake time consuming external searches.

III What are the legislative requirements for the use of indirect methods?

In most countries the right to use indirect methods derives from powers conferred on the tax authority to administer the relevant tax laws, including the assessment and collection of taxes due and payable under those laws. While indirect methods are usually not explicitly articulated in legislation; by giving the administration the authority to make estimated assessments, and remaining silent on the methods to be used, legislators have implied that the administration may choose a method that is appropriate to ascertain the tax payable. The support by courts of law in many jurisdictions has led to case law establishing indirect methods as being accepted as a fair and reasonable way of determining a taxpayer's income. Case law however has also placed some conditions and restrictions upon their usage.

As can be seen above, indirect methods come in many guises with a range of names, terminology, and approaches to execution. For example, the net worth method has also been described as an asset betterment or asset accretion method. To specifically legislate for the exhaustive use of indirect methods would require standardized definitions, descriptions, and explanations of computations and would lead to extremely voluminous and complex legislation. Laws therefore often provide for the administration to determine tax liabilities by making reasonable estimates.⁹ For example, in Australia, the commissioner “may make an assessment of the amount upon which in his judgment income tax ought to be levied.”¹⁰

As tax legislation does not usually stipulate how the administration is to arrive at a reasonable estimate or what factors need to be taken into account in making a judgment, it has been left up to the courts of law to rule on what is or is not reasonable. In the United States, the Supreme Court stated “**to protect the revenue from those who do not render true accounts, the Government must be free to use all legal evidence available to it in determining whether the taxpayer's books and records accurately reflect his financial history**” and that the indirect method used need not be exact, but must be reasonable in the light of surrounding facts and circumstances.¹¹ In Australia, the courts have held that an assessment will be valid if the Commissioner makes a genuine attempt to determine a taxpayer's taxable income. The estimation may go close to guesswork and yet be lawful¹² but a figure cannot simply be plucked out of the air.¹³ Therefore, the judgment of the taxpayer's income must be based on some reasonable or rational grounds. To provide a

⁹United Kingdom - VAT Act 1994 provides for use of best judgment. Japan - Income Tax Law and Corporations Tax Law authorizes using reasonable calculations. Austria – Fiscal Procedures Act permits estimation of profits and taxable income. New Zealand – Tax Administration Act 1994 allows the Commissioner to use his judgement.

¹⁰Income Tax Assessment Act 1936, section 167.

¹¹Holland v United States 121 (1954)

¹²Trautwein v. FCT (1936) 56 CLR 63

¹³Briggs (1986) 17 ATR 1031

sound basis for assessment and defend court challenges, administrations have adopted the formal methods described above which have a rational foundation and cannot be described as arbitrary. That is not to say that the methods described above are the only ones that can be used.

Although not prescribing the methods to be used, by commenting on legality and reasonableness of indirect methods, court decisions have in effect developed the conditions for their use. In general it can be said that courts have ruled that administrations: (1) may use any method to reconstruct income that is reasonable under the circumstances; (2) may not be arbitrary in the use of this authority; (3) may use an indirect method to test the accuracy of the taxpayer's books and records; (4) must investigate all reasonable evidence presented by the taxpayer refuting the computation of income; (5) determinations are presumed to be correct and the taxpayer bears the burden of proving that it is incorrect; (6) are not required to negate every possible non-taxable source for the unreported income in order to sustain a deficiency based on a reconstruction of income; and (7) may use third party records (customers, suppliers, etc.) in the reconstruction.

Importantly, legislation needs to provide the administration with wide powers for information gathering if indirect methods are to be used effectively. Powers should require taxpayers and third parties to provide any information that is related to the performance of the administration's functions under the law. This will usually enable the administration to collect sufficient evidence to base assessments on indirect methods.

Taxpayers are of course at liberty to challenge indirect method assessments in line with each jurisdiction's law governing appeals. However for the taxpayer to be successful he would usually need to establish a more reliable method of calculation or show that undeclared income was not from a taxable source. Although laws often place the burden of proof on the taxpayer, it is always helpful to the administration's case if the auditor can provide indications of likely sources of taxable income and negate taxpayer's contentions of non-taxable sources of income.

IV. In what circumstances is it appropriate to use indirect methods?

If an auditor is satisfied with the integrity of the taxpayer's records, there is no need to use an indirect method. However, if a taxpayer's books and records are inadequate or do not reflect the taxpayer's financial affairs, and the auditor suspects substantial under declaration of income, consideration should be given to using indirect methods. Factors indicating the need to adopt indirect methods include:

- Failure to file declarations and failure to maintain records.
- Unexplained wealth, or declared income does not reflect the taxpayer's standard of living.
- Declared income does not correspond to the business activity of the enterprise.
- Taxpayer consistently declares losses or insubstantial income for an extended period.
- Most business operations are in cash.
- Documents are incomplete, recordkeeping is poor, and internal controls are weak.

The choice of which indirect method to be used to reconstruct the taxpayer's correct income will be determined by the nature of the enterprise and facts and circumstances of the case. Availability of relevant data will be the critical factor. Indirect methods requiring analysis of wealth and private expenditure are generally more suitable for use in the case of physical persons. However, they can be appropriately used in the case of an enterprise that is closely owned and controlled by two or three individuals.

A heavy reliance on accurate banking analysis in the application of **net worth, bank deposits, and source and application of funds methods**, negates the use of these methods if access to banking records is not possible. In these cases it may be more appropriate to use **mark-up or unit and volume methods** to determine tax liabilities if there is information available which allows reliable extrapolation of the value of inputs or outputs. The latter methods can also be more suitable to the determination of indirect tax liabilities and can provide a quick test of the veracity of claims in income tax declarations.

As discussed above, industry benchmarks lend themselves to signaling high risk cases and have proved valuable in persuading taxpayers of the need to review their declarations. Administrations have found that by alerting taxpayers as to discrepancies in comparisons with industry averages, taxpayers figures have been reviewed and amended either through self assessment or during the audit process.

V. What is required to withstand challenges to indirect methods?

Success in sustaining assessments arising from audits using indirect methods lies in being able to foresee and overcome potential challenges. Indirect method assessments cannot be based on pure speculation; they must be supported by recognized and accepted techniques to deduce a taxpayer's liability. Thoroughness in preparation and execution of the audit is essential. An auditor's documentation must clearly demonstrate the rationale for the assessment, fully describe all the information used, and detail all computations.

Planning is the foundation for a quality audit and auditors need to be well prepared before commencing examinations of a taxpayer's financial affairs. Preparation should involve: (1) accessing and analyzing available information, both internally and externally, that may be of use during the audit, for example, tax returns, customs data, licensing information, readily available records held by other government agencies, authorities and third parties; (2) studying information available on the taxpayer and the industry they operate in and computing comparative ratios; (3) listing high risk or suspect areas or issues; and (4) planning the approach to the audit to address the risks, including preparation of questionnaires, checklists, and lead sheets indicating the examination methodology to be adopted to verify taxpayer claims.

The initial interview and observations of business operations are critical when the records are inadequate, nonexistent, or there is reason to believe that they are false. Frequently, the information obtained from the interview will determine the outcome of the audit. The interview

must be focused on auditing the taxpayer, not the taxpayer's books and records. As taxpayers may attempt to explain away an understatement of income by saying that it represents cash-on-hand, some gift or inheritance, savings from activities in previous periods, money "found", or loans from family, it is crucial that the auditor establishes and verifies income from non-taxable sources early in the course of the audit. Detailed questioning in the initial phases of the audit will lessen the likelihood of a taxpayer coming up with new explanations at the conclusion of the audit.

Documenting the audit procedures and rationale provides support in the case of a challenge. Even though the law may place the onus of proof on the taxpayer, the auditor must be able to provide evidence relevant to the methodologies adopted and the conclusions reached. In the absence of taxpayer's books and records, the auditor's contemporaneous working papers documenting what transpired during the audit, including taxpayer's answers to questions, third party information, subsidiary records, and observations of business operations, become instrumental to uphold an assessment. A clear articulation of the rationale for the methods used and validation by reference to pertinent legislation, case law, policy, and corroborating evidence of the likely sources of income, plus due consideration to any arguments or explanations offered by the taxpayer, will limit any potential defense from the taxpayer and strengthen the auditor's case.

Administrations should set down policy and procedures in manuals and practice statements to guide staff in the application of the relevant legislative powers.¹⁴ If policies are supported by legislation and case law, following the procedures set down in such documentation will lessen the chances of the taxpayer disproving the assessment. Furthermore, by maintaining up to date profiles of high risk industries and providing specific audit guidance notes in respect of such industries, administrations can aid auditor professionalism by developing highly trained examiners for a particular market segment. These guides¹⁵ may contain examination techniques, common and unique industry issues, business practices, industry terminology and other information to assist auditors in performing examinations.

Position papers should be provided to the taxpayer explaining the proposed adjustments and how they were derived. Generally, the taxpayer should be given an opportunity to review the proposed adjustments and provide any counter arguments before assessments are issued. All challenges need to be considered and if substantiated the audit report needs to be revised. In the case of bank deposits, net worth, and source and application of funds methods, the taxpayer's contentions usually revolve around either: (1) non-taxable sources of income; (2) cash on hand at the beginning of audit period; (3) overestimation of personal expenses; or (4) incorrect computation in areas of adjustments for matters such as accruals accounting or non-cash deductions. Auditors need to be well prepared for challenges and ensure that the taxpayer has already been questioned, preferably during the initial interview, and details of all stated sources of income, cash on hand, and personal

¹⁴For example, Australian Taxation Office – Practice Statement Law Administration, PS LA 2007/24; U.S.A – Internal Revenue Manual 4.10.4.6

¹⁵For example, IRS Construction Industry Audit Technique Guide (ATG) May 2009.

expenses have been recorded and where possible supported by corroborating evidence or a signed statement by the taxpayer. Computations need to be thoroughly checked before any statement is issued to the taxpayer and all items need to be explained in accompanying material.

The taxpayer needs to do more than just dismiss some figures used in the auditor's calculation or merely throw doubt upon the methodology used. Remembering that the administration has used indirect methods because the taxpayer has not fulfilled his record keeping obligations, the taxpayer is on the back foot and the courts will usually expect the taxpayer to come up with a stronger case than that presented by the tax administration. So unless the taxpayer can come up with reliable data to substantiate his assertions, the administration should issue assessments based on the indirect methods and then leave the taxpayer with the option to exercise his formal right of objection and appeal.

Sanctions need to be imposed for failure to file a declaration, failure to maintain adequate books and records, and underpayment of tax, irrespective of whether indirect methods are adopted. A robust and consistent penalty regime should act to deter taxpayers from waiting for the administration to raise default assessments and hence alleviate the significant workloads and costs on the administration in dealing with estimated assessments and the resultant challenges. Administrations that make a habit of issuing arbitrary estimated assessments, pursuing only primary tax, and remitting or not applying penalties, actually encourage taxpayers not to comply. In these circumstances it is in the taxpayer's interest to await action by the administration, challenge the assessment and negotiate a settlement rather than to comply with the respective obligations under the law.

VI. Key points for tax administration design.

Taxpayers need to be encouraged, through education and enforcement, to maintain accurate books and records that enable them to accurately determine their tax liabilities and also provide adequate audit trails. Indirect methods are not totally accurate, are costly to execute, and should only be used when it is highly likely that the taxpayer has significantly understated tax obligations.

Indirect methods provide administrators with a very valuable tool to establish the veracity of taxpayer declarations, encourage compliance, and establish a taxpayer's liability when records do not adequately reflect financial affairs and should therefore be incorporated in all audit programs. However, they are not always embraced by tax administrators due to limitations in accuracy, perceived lack of legislative support (particularly in under-developed legal systems), resource requirements, taxpayer challenges, demanding skill sets, lack of understanding, and difficulties in persuading the judiciary. To ensure effectiveness, indirect methods must be applied with some precision rather than being mere estimates of income. Therefore, administrations need to ensure that auditors are provided with the necessary legislative framework, data and intelligence on business operations, policy and procedural guidance, and training, to enable competent application of indirect methods.

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