

IRS and Taxes in the Cannabis Industry:

Risk Factors, Red Flags, and Investigation from an Examiner's Perspective

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ABSTRACT

Cannabis is a federally illegal, cash-intensive, lucrative industry that is at high risk for tax fraud... and the IRS is watching closely. CEOs need to be aware of the risk factors and red flags that the IRS looks for and how examiners use that information to tailor their investigations.

Cannabusiness owners also need to understand the examination procedures and investigative tools the IRS examiners employ – such as Cash-T Account Analysis, and Vertical and Horizontal Analysis of key business ratios – and how they can be used as evidence to build a case. Having a deeper understanding of tax fraud investigation from the examiner's perspective, CEOs can better defend themselves against fraud risk and the potential loss of their business assets and personal freedom.

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TAX PROBLEMS IN THE CANNABIS SPACE

The main financial problem in the cannabis space today centers around 26 US Code § 280E which denies cannabis businesses deduction of ordinary expenses that are available to other businesses, which, in turn, increases tax burden to levels intolerable to cannabis CEOs. This problem is exacerbated by the fact that cannabis CEOs are starting businesses with the goal of a fast and large exit, and a “do whatever it takes to get there” mindset.

In the short-sighted quest to “beat the IRS and 280E,” three main strategies have emerged: (1) Complex entity structure and cost movement; (2) Non-cannabis companies; and (3) Maximizing cost of goods sold (COGS). However, the IRS is fully aware of these aggressive strategies, and its examiners conduct investigations with them in mind, resulting in the courts deciding in favor of the IRS every single time.

This problem is further intensified by the fact that very few bookkeepers, accountants, and CPAs are experts in the space and are not properly trained as to how to help cannabis CEOs attain the exit and valuation desired while remaining compliant and “bullet-proof” when they are eventually audited by the IRS.

The Tax Code That Changed Everything

In response to the Tax Court decision in favor of the petitioner in *Jeffrey Edmondson v. Commissioner*¹ in 1981, legislation was passed in the form of **26 U.S.C. § 280E – Expenditures in connection with the illegal sale of drugs**² in 1982 to make sure that never happened again. Section 280E denies sellers of controlled substances the right to deduct ordinary and necessary business expenses as allowed in **26 U.S.C. § 162 – Trade or Business Expenses**³ that is afforded to other businesses. Under § 208E:

No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.

¹ *Jeffrey Edmondson v. Commissioner*, T.C. Memo. 1981-623.

² I.R.C. § 280E.

³ I.R.C. § 162.

According to the IRS⁴, “This applies to businesses that sell marijuana, even if they operate in states that have legalized the sale of marijuana, because trafficking marijuana remains illegal under the federal Controlled Substances Act.”

Although § 162 expenses are disallowed, the IRS stipulates that,

Section 280E does not, however, prohibit a participant in the marijuana industry from reducing its gross receipts by its properly calculated cost of goods sold to determine its gross income. The Internal Revenue Service takes the position that section 280E-affected taxpayers must calculate their cost of goods sold pursuant to Internal Revenue Code section 471 and the associated Treasury Regulations. Generally, this means taxpayers who sell marijuana may reduce their gross receipts by the cost of acquiring or producing marijuana that they sell, and those costs will depend on the nature of the business. For more detail, see Chief Counsel Advice 201504011 (released 1/23/2015).⁵

How §280E Hurts Cannabis Companies

To better understand how the restrictions of § 280E impact the bottom line of cannabis companies, some large companies are now adding § 280E-specific notations to their annual forms 10-K which help investors easily visualize the damage.

Example: Trulieve Cannabis Corp.

In the Notes to Consolidated Financial Statements section of Trulieve’s Form 10-K for the fiscal year ended December 31,2021⁶, Note 18. shows a reconciliation of the Federal statutory income tax rate percentage to the effective tax rate.

	Year Ended December 31,		
	2021	2020	2019
	<i>(in thousands)</i>		
Income before income taxes	\$ 163,506	\$ 157,449	\$ 103,681
Federal statutory rate	21.0%	21.0%	21.0%
Theoretical tax expense	34,336	33,064	21,773
State taxes	25,417	12,407	9,477
Other	681	(1,666)	1,310
Tax effect of non-deductible expenses:			
Section 280E permanent differences	85,627	50,646	18,026
	111,725	61,387	28,813
Tax expense	\$ 146,061	\$ 94,451	\$ 50,586

⁴ IRS, “I operate a business that consists of selling marijuana. Can I claim deductions to determine my taxable income?” *Marijuana Industry Frequently Asked Questions*, <https://www.irs.gov/businesses/small-businesses-self-employed/marijuana-industry-frequently-asked-questions>.

⁵ Ibid.

⁶ Trulieve Cannabis Corp., Form 10-K, Dec. 31, 2021, SEC Edgar, p. F-42, <https://www.sec.gov>.

Looking at the amounts shown in the above example, Trulieve’s net income before income taxes for 2021 was \$163.5 million. If Trulieve was not a cannabis business, it would be taxed at the Federal corporate statutory rate of 21.0% and would owe Federal income tax of \$34.3 million (shown above as “Theoretical tax expense”). However, due to the restrictions of § 280E, Trulieve paid total income taxes of approximately \$146.1 million (shown above as “Tax expense”).

The effective tax rate is calculated by dividing the taxes paid (shown as “tax expense” in the above example) by the net income before taxes. This calculates to an effective tax rate of 89.3% for 2021, which is 3.25 times what non-cannabis corporations pay at the Federal statutory rate of 21.0%. This translates to an additional \$85.6 million in taxes paid to the Federal government due to the restrictions of § 280E. This is shown as “Section 280E permanent differences” in the example above. In 2021, Trulieve paid a total of \$120 million in taxes to the IRS (\$34,336,000 Federal statutory rate, plus \$85,627,000 due to § 280E). Looking at just the federal tax bill, Trulieve paid federal taxes at an effective rate of 73.4%. The devastating effect is shown clearly in the Consolidated Statements of Operations and Comprehensive Income from the Form 10-K⁷ shown below:

TRULIEVE CANNABIS CORP.			
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME			
<i>(in thousands, except per share data)</i>			
	2021	2020	2019
Revenues, net of discounts	\$ 938,385	\$ 521,533	\$ 252,819
Cost of goods sold	372,255	135,116	60,982
Gross profit	566,130	386,417	191,837
Expenses:			
Sales and marketing	215,144	119,395	59,349
General and administrative	100,573	36,056	14,071
Depreciation and amortization	48,096	12,600	5,079
Loss on impairment and disposal of long-lived assets	5,371	63	67
Total expenses	369,184	168,114	78,566
Income from operations	196,946	218,303	113,271
Other income (expense):			
Interest expense	(34,787)	(20,237)	(9,050)
Change in fair value of derivative liabilities - warrants	208	(42,679)	(806)
Other income, net	1,139	2,062	266
Total other expense	(33,440)	(60,854)	(9,590)
Income before provision for income taxes and non-controlling interest	163,506	157,449	103,681
Provision for income taxes	146,061	94,451	50,586
Net income and comprehensive income	17,445	62,998	53,095

The Income before provision for income taxes and non-controlling interest shows here as \$163,506,000 (the same as “Income before income taxes” in the reconciliation above), and the taxes paid are shown on the line below it as \$146,061,000. Subtracting the taxes paid from the net income reveals the net income available to the company’s shareholders. In 2021, Trulieve paid out \$120 million in taxes to the federal government, while its shareholders ended up with a mere \$17.4 million, representing 10.6% of net income and only 1.9% of gross revenue. In other words, for every dollar put into a cash register at a Trulieve facility, the shareholders get to keep almost two pennies.

⁷ Ibid, p. F-5.

Impact and Implications

Section 280E was enacted to penalize illegal drug traffickers in the illegal drug environment of the 1980s, but now creates challenges for state-legal businesses in the evolving cannabis space. The high federal taxes paid out reduces the amount of capital available to cannabis businesses to expand and grow, increasing the need to sell additional shares of stock to raise more capital. Or, cannabis businesses may choose to borrow needed capital, which presents its own set of challenges. Once a cannabis-friendly lender is located and a loan is secured, cannabis companies pay higher than normal interest rates, and that interest is, of course, not deductible as an operating expense under § 280E.

Investors, as well as those interested in mergers and acquisitions, also need to be aware that § 280E wreaks havoc on a cannabis company's financial metrics. EBITDA (earnings before interest, taxes, depreciation, and amortization) is a key metric used by investors as a measure of a company's overall financial performance. It is important for investors to remember that EBITDA excludes both taxes and interest which can both be quite large for cannabis companies relative to other industries. Investors also need to be aware that cash flow from operations and net income for cannabis companies are depressed by the large tax payments to the federal government.

Accountants and tax professionals need to have an intimate knowledge of § 280E and must also know how to apply it properly to avoid unintentional and adverse consequences to their clients. Errors made by unqualified individuals could have a significant impact on the financial health of the company as well as the personal lives of CEOs and other stakeholders.

How Cannabis Taxpayers Reacted

Because § 280E increases tax burden to levels intolerable to cannabis CEOs, many have attempted to challenge, circumvent, or even just ignore the tax code, in order to avoid paying such a huge amount in taxes each year. Three main strategies have emerged in the cannabis space: Complex entity structures and cost movement, the creation of non-cannabis companies, and maximizing cost of goods sold under the provisions of 26 U.S.C. § 471.

Complex Entity Structure and Cost Movement

A complex entity structure refers to a business with several layers of ownership entities. In and of itself, setting up a complex corporate structure is not illegal, and most are not set up with ill intent, and most do not start out that way. In common practice, most businesses start out with a simple structure and then turn into something quite complex as the business grows over time.

Any business that develops a complex entity structure at the onset will be scrutinized more closely by fraud examiners because they are a hallmark of both tax evasion and money laundering schemes. If a complex entity structure is warranted, care must be taken with intercompany transactions to ensure transparency and compliance, and to avoid the appearance that the business's structure was developed for the sole purpose of circumventing the tax code.

Non-Cannabis Companies

Another strategy employed by some cannabis companies in an attempt to lower their tax burden is to set up separate non-cannabis entities. This is different than a complex entity structure in that there are multiple entities with usually one owner, rather than one company that owns several others. Cannabis owners employing this strategy mistakenly believe that by setting up several different entities they can allocate expenses to the non-cannabis companies that are not subject to the restrictions of §280E.

However, having multiple entities does not mean that there is more than one business for the purposes of § 280E. This strategy is nuanced but can be executed correctly with an expert cannabis accounting professional. Where businesses get into trouble is when they follow the advice of either a novice/general accountant who does not fully understand the proper application of the tax code, or an overly aggressive accounting professional who believes they can “beat” the tax code. Businesses get into real trouble when the entities formed are not profitable, nor substantial enough, on their own, and when they are not accounted for both separately and accurately.

Maximizing Cost of Goods Sold (§ 471)

The third strategy employed by cannabis companies in reaction to § 280E is attempting to increase cost of goods sold, thereby reducing taxable income. Taxable income is computed by subtracting out all the costs directly associated with selling a good or service (Cost of Goods Sold, or COGS) from the revenue generated by selling the good or service (Net Sales), and then subtracting all the indirect expenses (Operating Expenses) the company incurred in its pursuit of profit. Subtracting COGS from Net Sales gives a company’s Gross Profit. Subtracting Operating Expenses from Gross Profit gives a company’s Net Income, which is generally the amount subject to income tax. For example:

a)

Net Sales	\$ 250,000
Cost of Goods Sold (COGS)	<u>(125,000)</u>
Gross Profit	125,000
Operating Expenses	<u>(110,000)</u>
Net Income	<u>\$ 15,000</u>

Using the above example, tax is then calculated by multiplying the \$15,000 in net income by the Federal statutory rate of 21.0% (if the company is a corporation), yielding a federal income tax due of \$3,150. This is for a non-cannabis corporation.

If the company is a cannabis corporation, § 280E would apply, and the operating expenses would be disallowed, as shown below:

b)

Net Sales	\$ 250,000
Cost of Goods Sold (COGS)	<u>(125,000)</u>
Gross Profit	125,000
Operating Expenses	<u>-</u>
Net Income	<u>\$ 125,000</u>
Federal Statutory Tax Rate	21.0%
Federal Income Taxes Due	\$ 26,250

This shows the same dramatic increase in taxes due as discussed in the previous Trulieve Cannabis Corp. example.

Section 280E directs the taxpayer to, “calculate their cost of goods sold pursuant to Internal Revenue Code section 471 and the associated Treasury Regulations. Generally, this means taxpayers who sell marijuana may reduce their gross receipts by the cost of acquiring or producing marijuana that they sell, and those costs will depend on the nature of the business.”⁸ **26 U.S.C. § 471 – General rule for inventories**⁹, states (in part):

(a) General rule

Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

(b) Estimates of inventory shrinkage permitted *(Omitted for brevity.)*

(c) Exemption for certain small businesses

(1) In general

In the case of any taxpayer (other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)) which meets the gross receipts test of section 448(c) for any taxable year—

(A) subsection (a) shall not apply with respect to such taxpayer for such taxable year, and

(B) the taxpayer’s method of accounting for inventory for such taxable year shall not be treated as failing to clearly reflect income if such method either—

(i) treats inventory as non-incident materials and supplies, or

⁸ I.R.C § 280E.

⁹ I.R.C. § 471.

(ii) conforms to such taxpayer’s method of accounting reflected in an applicable financial statement of the taxpayer with respect to such taxable year or, if the taxpayer does not have any applicable financial statement with respect to such taxable year, the books and records of the taxpayer prepared in accordance with the taxpayer’s accounting procedures.

(Remainder omitted for brevity.)

Subsection (a) above permits the taxpayer to value their inventory, “to the best accounting practice in the trade or business and as most clearly reflecting the income.” This would result in a company calculating its cost of goods sold as expenses directly involved in the sale of inventory such as the cost of items purchased for resale, raw materials, freight charges, and factory labor. All other indirect expenses such as advertising, rent, staff salaries, telephone and internet services, and repairs and maintenance would then be categorized as operating expenses. (More specific guidance for retail establishments can be found in **CFR § 1.471-3 – Inventories at cost**, and for cultivators, processors, and manufacturers of edibles at **CFR § 1.471-11 – Inventories of manufacturers**.)

Some cannabis companies and their accountants have interpreted subsection (c) above to allow for ALL expenses to be accounted for as cost of goods sold because (they claim) the companies are exempt from subsection (a). Such interpretation would allow a company to show the same net income as in example “a)” above (shown here again for convenience):

a)

Net Sales	\$ 250,000
Cost of Goods Sold (COGS)	(125,000)
Gross Profit	125,000
Operating Expenses	(110,000)
Net Income	\$ 15,000

This would be accomplished by adding all operating expenses to cost of goods sold as shown below:

c)

Net Sales	\$ 250,000
Cost of Goods Sold (COGS)	(235,000)
Gross Profit	15,000
Operating Expenses	-
Net Income	\$ 15,000
Federal Statutory Tax Rate	21.0%
Federal Income Taxes Due	\$ 3,150

While this would produce the desired result of an effective tax rate of 21.0%, it would most likely result in the IRS challenging this method and asking for substantiation of the items in cost of goods sold. Using this method also means that the company has inaccurate accounting which will produce meaningless financial statements. Management will not be able to make good decisions based on these statements. Investors and lenders will most likely shy away from a company with no real accounting, and valuation will be irrelevant, compromising even the best exit strategy.

What Makes Things Worse

As evidenced above, remaining compliant in the cannabis space is challenging on its own. But because the industry is incredibly dynamic and not yet mature, there are additional factors present in the industry that make things even worse. Some of these factors can be eliminated or mitigated by CEOs, some are completely out of their hands.

CEO Mindset and Aggressive Strategies

Many cannabis CEOs are starting businesses with the goal of a fast and large exit, rather than to build a brand and a legacy. While a cooler head may prevail at the beginning, the mindset sometimes changes into “do whatever it takes to get there.” Once this mental shift occurs, there is also a shift in the risk/reward dynamic. At this point, CEOs will be willing to take greater risks in order to obtain the reward of a large exit. This leads to a short-sighted mission to “beat the IRS and 280E,” and CEOs will begin to employ some of the aggressive strategies mentioned in the section above. The IRS is watching and patiently waiting for this to happen.

Non-Cannabis Bookkeepers and Accountants

Unless CEOs do their own books, they rely on the help and guidance of accounting professionals. Because the industry is so young, and because experienced bookkeepers and accountants are still reluctant to work with cannabis businesses for fear of “going down with the ship,” there are very few bookkeepers and accountants that are experts in the space.

The ones that are willing to work with cannabis businesses are not properly trained as to how to help CEOs attain the exit and valuation desired, while remaining compliant and “bullet-proof” when they are eventually audited by the IRS. They are misinterpreting tax codes in an effort to increase deductions that businesses may not be allowed to take. In addition, the cost accounting required to determine which costs can be allocated to inventory as cost of goods sold is highly complex, and without proper training, is beyond most generalist bookkeepers and accountants. Companies in the cannabis space need to have solid annual, quarterly, monthly, weekly, and daily procedures in place, as well as a vertical-specific chart of accounts and impeccable supporting documentation, to strictly adhere to both GAAP (Generally Accepted Accounting Principles) and the tax code.

Non-cannabis accounting professionals unknowingly put their business and CEO at risk of large penalties and fees or being shut down (or worse) for not complying with the tax code. The IRS is intimately aware of every section and subsection of the tax code and how they are to be applied, as well as all tax court rulings. Cannabis bookkeepers and accountants need to be on even ground with the IRS agents so they can confidently stand toe-to-toe with them during an audit and defend their position and their CEO.

Cash-Intensive Business

The IRS defines a cash intensive business as, “one that receives a significant amount of receipts in cash.”¹⁰ These types of businesses draw extra scrutiny by the IRS because:

The accurate reporting of income and expenses by cash intensive businesses has been the subject of various studies by the Service, as well as General Accounting Office (GAO). The GAO estimates that the individual income tax "gap" is in the hundreds of billion of dollars. The common theme of these studies is that there has been, for those taxpayers with the ability to determine their own reported income, an increasing underreporting of income.

Of particular interest are businesses and individuals who receive most of their income in cash. Cash transactions are anonymous, leaving no trail to connect the purchaser to the seller, which may lead some individuals to believe that cash receipts can be unreported and escape detection.

There are three main ways to misappropriate cash from a business.

- It can be skimmed from receipts, for example, pocketed before it is recorded. If this happens it will not be discovered by auditing the books.
- It can be stolen after it has been recorded, for example, cash removed from the cash register or goods stolen from the shelf for future resale.
- A fraudulent disbursement can be created, for example, a payment to a vendor that is actually cashed by the owner’s son.¹¹

Because the IRS scrutinizes cash-intensive businesses more than other businesses, it is even more important for cannabis businesses that deal mostly in cash to implement solid internal controls like paying bills timely, maintaining pristine records of each payment and receipt, daily cash counts, and proper segregation of duties.

Underground Economy (Diversion and Inversion)

The IRS is aware that there is an underground economy, that cash-intensive businesses are very susceptible to exposure, and that cannabis diversion and inversion happen. According to the IRS:

The underground economy represents income earned under the table and off the books. It can include legal and illegal, or black market, goods, including drug sales, money laundering and warehouse banking schemes. The underground economy is characterized by small, single, entrepreneurial businesses that can receive payment for

¹⁰ IRS, “Cash Intensive Business Audit Techniques Guide (ATG),” Ch. 1, p. 5, www.irs.gov.

¹¹ Ibid, Ch. 1, p. 2.

their goods or services in the form of cash or bartered goods. The main goal is to avoid reporting income and paying taxes to governments.

Whenever income is not subject to information reporting or cannot be verified by a third party there is a risk that some or all of it may not be reported. Hand in hand with unreported income is the possibility that bona fide net business income will be understated due to excess expenses, either personal or the expenses to produce the unreported income.¹²

To assist with the enforcement of regulations, tax collection, and preventing illegal diversion and inversion, state and local governments have mandated the use of “seed-to-sale” tracking throughout the production lifecycle.

Seed-to-sale is a term used to describe the process of tracking a cannabis plant from the time a seed is planted through grow, harvest, dry, cure, trim, lab testing, sale to processor, conversion to “oil,” then sale to the manufacturer, then sale to the retailer, then final sale to the consumer. This is a very complex endeavor that is made easier with specific seed-to-sale software, but cannabis companies through all verticals and at all levels of jurisdiction remain subject to intense scrutiny.

TAX FRAUD INVESTIGATION

Fraud Definitions and Legal Requirements

Fraud in General

Definition of Fraud

In legal terms, “allegations of fraud might be based on a misrepresentation of fact that was either intentional or negligent. For a statement to be an intentional misrepresentation, the person who made it must either have known the statement was false or been reckless as to its truth. The speaker must have also intended that the person to whom the statement was made would rely on it. The hearer must then have reasonably relied on the promise and also been harmed because of that reliance.”¹³

According to the IRS, “Fraud is deception by misrepresentation of material facts, or silence when good faith requires expression, which results in material damage to one who relies on it and has the

¹² Ibid, Ch. 8, p. 2.

¹³ “Fraud,” Wex Legal Dictionary, Legal Information Institute, Cornell Law School, law.cornell.edu/wex.

right to rely on it. Simply stated, it is obtaining something of value from someone else through deceit.”¹⁴

Major Categories of Fraud

Fraud schemes fall into one of two broad categories: Internal (Occupational) Fraud or External Fraud.

- **Internal Fraud** schemes are offenses committed by employees and include:
 - **Asset Misappropriations:** The theft or misuse of an organization’s assets. For example, skimming cash and checks, stealing inventory, and payroll fraud.
 - **Corruption:** The unlawful or wrongful misuse of influence in a business transaction to procure personal benefit, contrary to an individual’s duty to his or her employer or the rights of another. Examples of corruption include bribery, kickbacks, and conflicts of interest.
 - **False Statements:** The intention misrepresentation of financial or non-financial information to mislead others who are relying on it to make economic decisions. Examples include overstating revenues on financial statements, understating liabilities or expenses on financial statements, and making false statements regarding the safety and prospects of an investment.
- **External Fraud** schemes are offenses committed against other entities and include:
 - **Individuals against Other Individuals**, such as con schemes and identity theft,
 - **Individuals against Organizations**, such as insurance fraud or tax fraud, and
 - **Organizations against Individuals**, such as consumer frauds.

Legal Elements and Attributes of Fraud

According to the law, fraud has four legal elements that are essential requirements that must be met to make a claim in court and are integral to the legal definition stated above. These four elements are:

1. A material¹⁵ false statement with the intent to deceive,
2. Knowledge that the statement was false when it was made,
3. Reliance on the false statement by the victim, and
4. Damages resulting from the victim’s reliance on the false statement.

Therefore, to prove fraud, all four elements must be present. Someone (perpetrator) must have knowingly made a materially false statement with the intention to deceive someone else (victim), who made a decision based on that information that resulted in damages to the victim.

¹⁴ IRS, “Internal Revenue Manual (IRM) Part 25.1, Fraud Handbook,” 25.1.1.1.7, Apr. 22, 2021, [irs.gov/irm/part25](https://www.irs.gov/irm/part25).

¹⁵ Significant; large enough to influence decisions.

- **The Problem with Intent**

An integral part of fraud is that the person who committed fraud (perpetrator) *intended to deceive* their victim. There is no such thing as accidental fraud. Therefore, to prove fraud, the investigator must deal with the issue of intent. In a fraud case, evidence of intent is usually circumstantial – unless there is a confession of the perpetrator or a co-conspirator. Fraud investigators look for evidence of the attributes of fraud (act, concealment, and conversion).

- **Attributes of Fraud**

The three attributes of fraud are the act, the concealment, and the conversion.

- **The act** represents the execution and methodology of the fraud. Evidence of the act can be gathered through surveillance of the suspect and document examination, as well as interviewing and interrogation of the suspect and others.
- **Concealment** represents disguising or hiding the fraud, such as creating false journal entries, falsifying bank reconciliations, or destroying records. Evidence of concealment can be obtained through audits, document examination, computer searches, and interviewing and interrogation.
- **Conversion** is the process of turning ill-gotten gains into something of value to the perpetrator. Conversion is completed in such a way that the benefit appears to come from legitimate sources such as laundered money, loan proceeds, an inheritance, or lottery winnings. Evidence of conversion can be obtained through public records searches, examination of the suspect's bank account, interviewing and interrogation, and indirectly using financial profiling techniques such as net worth analysis, lifestyle probes, bank records analysis, and the Cash-T Account Analysis.

- **Proving Intent**

If an investigator has evidence that the alleged perpetrator committed the act, benefited from that act, and concealed his or her activities, it becomes more difficult for the accused (the defendants) to argue that they did not intend to cause harm or injury. Evidence of concealment, in particular, provides some of the best evidence that the act, fraud or otherwise, was intentional.

Indicators of Fraud (Red Flags)

In order to determine if fraud may be occurring, fraud investigators look for anomalies called indicators or symptoms of fraud, which are more commonly called “red flags.” There are six major categories of red flags:

Analytical Anomalies: Transactions or financial statement relationships that do not make sense. Examples include:

- Unusual or missing items
- Larger or smaller than usual items
- No pattern when we would expect one

- A break in a pattern that is unexpected
- Round, even transaction amounts
- Cash transactions instead of transactions by check
- Large consistent transactions
- Unusual timing of transactions
- Unexplained transaction recipients or beneficiaries
- Unexplained cash or inventory shortages
- Deviations from specifications
- Increased scrap
- Excessive purchases
- Too many credit or debit memos
- Significant unexpected changes in account balances
- Excessive late charges
- Unreasonable expenses
- Unusual expense reimbursements
- Strange relationships between accounts
 - Revenues increasing
 - But inventory decreasing
 - But accounts receivable decreasing
 - But accounts receivable increasing at a greater percentage
 - But decreasing cash flows from operations
 - Inventory increasing
 - But accounts payable decreasing
 - But decreasing warehouse costs
 - Increased volume
 - But increased cost per unit
 - But decreased scrap

Accounting Anomalies: Unusual activities that seem to violate normal expectations for the accounting system. Examples include:

- Missing documents
- Old items being carried on bank and other account reconciliations from one period to the next period
- Excessive voids or credit memos
- Common names, addresses, or phone numbers of payees or customers
- Names, addresses, or phone numbers that are the same as those of employees
- Increases in past due accounts receivable
- Excessive write-offs of accounts receivable
- Increases in the number and amount of reconciling items
- Alterations on documents
- Duplicate payments

- Second endorsements on checks
- Breaks in check, invoice, purchase order, and other document number sequences
- Questionable handwriting
- Photocopied documents
- Irregular or undocumented journal entries

Internal Control Irregularities and Weaknesses: Controls necessary to safeguard assets and maintain the integrity of the financial reporting processes.

Each accounting process has several steps, and each step has controls in place to ensure that the transaction (underlying activity):

- exists
- is complete (detailed supporting documentation)
- accurate (properly valued)
- classified properly, recorded in the proper period
- posted and summarized properly in the financial statements

The normal internal control environment is expected to have several control activities including:

- Adequate separation of duties
- Proper authorization of transactions and activities
- Adequate documents and records
- Physical control over assets and records
- Independent checks on performance

Typical internal control weaknesses

- Lack of segregation of duties
- Lack of physical safeguards
- Lack of independent checks
- Lack of proper authorization
- Lack of proper documentation and other records
- Override of existing internal controls by an individual, management, or through collusion
- Inadequate accounting system
- Inadequate employee education (expectations)
- Reactive fraud detection approach
- Inadequate surprise audits
- Inadequate whistleblower opportunities and protection

Lifestyle Symptoms: Few perpetrators save what they steal. Most spend their ill-gotten gains almost immediately. Indicators that suggest a perpetrator is living a lifestyle outside their legal means include:

- Expensive cars
- Expensive homes
- Expensive boats
- Expensive jewelry

- Expensive clothing
- Other material possessions an employee could not, or should not, be able to afford

When confronted, most will have a quick explanation such as a recent inheritance, winning the lottery, or the promotion of a spouse.

Unusual Behaviors: Behaviors caused by the stress of concealing the fraud. These include:

- Insomnia
- Alcohol abuse
- Irritability
- Paranoia
- Inability to relax
- Inability to look people in the eye
- Signs of embarrassment
- Defensiveness
- Argumentativeness
- Belligerence
- Confession to a trusted confidant
- Attributing failure to others (scapegoats)
- Excessive smoking or starting smoking
- Other anxiety-based symptoms

Anomalies Communicated via Tips and Complaints: 42% of all frauds worldwide are identified by whistleblowers, making it the most effective means of identifying fraud by a wide margin over the next method of internal audit, which uncovered 16% of the frauds committed across the globe.¹⁶

Evaluation of Red Flags

Most red flags are not indicators of fraud but are a function of the dynamic environment in which organizations operate. Red flags need investigation until evidence suggests the anomaly is innocuous. Fraud investigators ask themselves a series of questions to help them determine if a red flag is an indicator of fraud such as:

- Does the anomaly have supporting documentation?
- Does the documentation appear to be falsified, altered, or fictitious?
- Do the transaction and its reflection in the financial statements make sense?
- Does the transaction make sense in the light of the business's operations, goals, and objectives?
- Does the totality of this and similar transactions make sense analytically when evaluated in comparison to the economy, the industry, key competitors, and other related accounting numbers within the organization?

¹⁶ ACFE (Association of Certified Fraud Examiners), "Occupational Fraud 2022: A Report to the Nations," p. 22, acfe.com.

- Does the transaction have proper approval and the proper authority levels?
- Does anything else about the transaction or its nature make it appear suspicious?

Fraud Risk Factors

A crucial part of fraud investigation, and even routine auditing, is identifying fraud risk factors associated with the company being investigated. Once identified, the examiner has a better understanding of what fraud schemes could be occurring. Fraud risk factors fall into three categories: motivational, situational, and behavioral. These will be discussed in greater detail in a later section.

Tax Fraud

Tax Fraud vs. Fraud in General

As discussed earlier, there are two major categories of fraud, internal and external. Tax fraud is a specific type of fraud that falls into the latter category. Tax fraud is an external fraud perpetrated by an individual (taxpayer) against an organization (the IRS). More specifically, “Tax fraud is often defined as an intentional wrongdoing, on the part of a taxpayer, with the specific purpose of evading a tax known or believed to be owing. Tax fraud requires both:

- a tax due and owing; and
- fraudulent intent.”¹⁷

Tax Evasion vs. Tax Avoidance

Tax avoidance consists of using legal means and methodologies to minimize taxes within the existing framework or tax rules and regulations, whereas **tax evasion** is a fraud scheme. According to the IRS:

Avoidance of tax is not a criminal offense. Taxpayers have the right to reduce, avoid, or minimize their taxes by legitimate means. One who avoids tax does not conceal or misrepresent, but shapes and preplans events to reduce or eliminate tax liability within the parameters of the law.

Evasion involves some affirmative act to evade or defeat a tax, or payment of tax. Examples of affirmative acts are deceit, subterfuge, camouflage, concealment, attempts to color or obscure events, or make things seem other than they are.

Common evasion schemes include:

- Intentional understatement or omission of income;

¹⁷ IRS, “IRM Fraud Handbook,” 25.1.1.3.

- Claiming fictitious or improper deductions;
- False allocation of income;
- Improper claims, credits, or exemptions; and/or
- Concealment of assets.¹⁸

Furthermore, tax evasion is a criminal act per 20 U.S.C. § 7201, which states:

Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.¹⁹

Legal Factors of Tax Fraud

Requirements of Proof: “Understanding the requirements of proof is essential in establishing fraud. In all criminal and civil tax fraud cases, the burden of proof is on the government. The major difference between civil and criminal fraud is the degree of proof required.

- In criminal cases, the government must present sufficient evidence to prove guilt beyond a reasonable doubt.
- In civil fraud cases, the government must prove fraud by clear and convincing evidence.²⁰

Legal Requirements: In order to be prosecutable, tax fraud requires: (1) an intentional wrongdoing with the specific purpose of evading a tax; (2) that the taxpayer actually owes taxes; and (3) at least one “affirmative act” to demonstrate intent. Affirmative acts are compelling actions that establish intent (deliberate action) and often focus on concealment. As stated in the earlier section, concealment is evidence of fraud. The primary distinction between whether a taxpayer has committed tax fraud, or simply committed an error, is the intent of the taxpayer. Presence of affirmative acts demonstrates intent.

Indicators of Fraud vs. Affirmative Acts of Fraud

- **Indicators of Fraud²¹:**
 - a. Taxpayers who knowingly understate their tax liability often leave evidence in the form of identifying earmarks (or indicators).

¹⁸ Ibid, 25.1.1.3.3.

¹⁹ I.R.C § 7201.

²⁰ IRS, “IRM Fraud Handbook,” 25.1.1.3.1.

²¹ Ibid, 25.1.1.4.

- b. Indicators of fraud serve as a sign or symptom, or signify that actions may have been taken for the purpose of deceit, concealment or to make things seem other than what they are. Indications, in and of themselves, do not establish that a particular action was taken.
- c. Examples include substantial unexplained increases in net worth, substantial excess of personal expenditures over available resources, bank deposits from unexplained sources substantially exceeding reported income, and documents that appear to be altered or false.
- **Affirmative Acts (Firm Indications) of Fraud:**
 - a. Affirmative acts of fraud are those actions that establish that a particular action was deliberately done for the purpose of deceit, subterfuge, camouflage, concealment, some attempt to color or obscure events, or make things seem other than what they are.
 - b. Fraud cannot be established without affirmative acts of fraud.
 - c. Examples include deliberate or intentional omission of specific items where similar items are included; concealment of bank accounts or other assets; willful failure to deposit receipts to business accounts; and covering up sources of receipts.²²

Examples of Affirmative Acts:

- **Deceit:** Lying when giving statements
- **Subterfuge:** An artifice (plan/scheme) to hide an act (evade a rule)
- **Camouflage:** Coloring events to hide them or to make them appear differently
- **Concealment:** Obscuring events to hide them or to make them appear differently

Civil vs. Criminal

“Civil fraud results in a remedial action taken by the government, such as assessing the correct tax and imposing civil penalties as an addition to tax, as well as retrieving transferred assets. Civil penalties are assessed and collected administratively as part of the unpaid balance of assessment.”²³

Criminal fraud results in a punitive action with penalties consisting of fines and/or imprisonment. Criminal penalties:

- Are enforced only by prosecution;
- Are provided to punish the taxpayer for wrongdoings; and
- Serve as a deterrent to other taxpayers.

A tax fraud offense may result in both civil and criminal penalties. Restitution may be ordered in criminal tax cases pursuant to a plea agreement or a conviction under Title 18 U.S.C. and may be required as a condition of probation.²⁴

²² Ibid.

²³ Ibid, 25.1.1.3.2.

²⁴ Ibid.

Tax Laws and Penalties for Fraud Perpetrators

Law	Nature of Law	Penalties
26 USC § 7201	Attempt to evade or defeat tax	<ul style="list-style-type: none">• Imprisonment - not more than 5 years• Fine - not more than \$250,000 for individuals (\$500,000 for corporations)• Or both, together with the costs of prosecution
26 USC § 7202	Willful failure to collect or pay over tax	<ul style="list-style-type: none">• Imprisonment - not more than 5 years• Fine - not more than \$250,000 for individuals (\$500,000 for corporations)• Or both, together with the costs of prosecution
26 USC § 7203	Willful failure to file return, supply information, or pay tax	<ul style="list-style-type: none">• Imprisonment - not more than 1 year• Fine - not more than \$100,000 for individuals (\$200,000 for corporations)• Or both, together with the costs of prosecution
26 USC § 7206	Fraud and false statements	<ul style="list-style-type: none">• Imprisonment - not more than 3 years• Fine - not more than \$250,000 for individuals (\$500,000 for corporations)• Or both, together with the costs of prosecution
26 USC § 7212(A)	Attempts to interfere with administration of Internal Revenue laws	<ul style="list-style-type: none">• Imprisonment - not more than 3 years• Fine - not more than \$250,000 for individuals (\$500,000 for corporations)• Or both

A full list of criminal violations is included as Appendix B.

Tax Fraud Investigation Process

How Investigations are Initiated

The process of investigating tax fraud starts with the observation of affirmative indicators (signs of potential fraudulent conduct) and concludes with either a finding of no fraud or a finding of tax evasion due to the presence of affirmative act(s). If predication exists that tax fraud might be present, the investigation can begin.

The Internal Revenue Service (IRS) is responsible for determining, assessing, and collecting taxes imposed by Congress. The Criminal Investigations Division (CID) is the law enforcement division of the IRS.

The Internal Revenue Service Criminal Investigation Division conducts criminal investigations regarding alleged violations of the Internal Revenue Code, the Bank Secrecy Act and various money laundering statutes. The findings of these investigations are referred to the Department of Justice for recommended prosecution.

Sources of Criminal Investigations for IRS Special Agents

Criminal Investigations can be initiated from information obtained from within the IRS when a revenue agent (auditor) or revenue officer (collection) detects possible fraud. Information is also routinely received from the public as well as from ongoing investigations underway by other law enforcement agencies or by United States Attorneys [*sic*] offices across the country.²⁵

IRS Resources

Two of the resources used by the IRS when conducting investigations are available to the public.

Internal Revenue Manual (IRM) 25.1 Fraud Handbook

Purpose. This IRM section provides direction and guidance for IRS employees servicewide when working potential fraud cases.²⁶

Audience. This handbook is a comprehensive guide for IRS employees servicewide in the recognition and development of potential fraud issues; referrals for criminal fraud; duties and responsibilities in joint investigations; civil fraud cases; and other related fraud issues.²⁷

Background. This IRM section provides an overview of fraud, defines the elements of fraud, and provides information for potential fraud examinations and procedures that examiners should understand and apply in the performance of their duties.²⁸

Roles and Responsibilities. Employees who work potential fraud cases are responsible for following the procedures in this IRM. All examiners and their managers working potential fraud cases should familiarize themselves with the information contained in this IRM.²⁹

Audit Techniques Guides (ATGs)

These Audit Techniques Guides (ATGs) help IRS examiners during audits by providing insight into issues and accounting methods unique to specific industries.

²⁵ IRS, "How Criminal Investigations are Initiated," irs.gov.

²⁶ IRS, "IRM Fraud Handbook," 25.1.1.1.

²⁷ Ibid.

²⁸ Ibid, 25.1.1.1.1.

²⁹ Ibid, 25.1.1.1.3(3).

While ATGs are designed to provide guidance for IRS employees, they're also useful to small business owners and tax professionals who prepare returns.³⁰

ATGs explain industry-specific examination techniques and include common, as well as, unique industry issues, business practices and terminology. Guidance is also provided on the examination of income, interview techniques and evaluation of evidence. So they may be helpful for business and tax planning purposes.³¹

Cash Intensive Businesses

Publication Date: 04/2010

Businesses that have substantial cash transactions are included in the consolidated Cash Intensive Businesses Audit Techniques Guide. Some of these businesses include bail bond, beauty shops, car washes, check cashing establishments, coin operated amusements, laundromats, scrap metal, some convenience stores and Taxicabs. Guidance is also provided on examination of income, interview techniques, and evaluation of evidence.³²

Step 1: Evaluate Risk Factors

The first step in the fraud investigation process is to identify and evaluate the fraud risk factors of the business in question so the examiner can identify the possible fraud schemes that may be occurring and what symptoms (indicators) they may exhibit. This helps the examiner focus on the relevant indicators. For example, if a business deals mostly in cash, the examiner will look for cash-related fraud symptoms.

Motivational Risk Factors are risk factors associated with the motivation of management. As previously discussed, many cannabis CEOs are focused on short-term results and/or personal gain. This puts the business at risk for fraud because there is an increased likelihood that the CEO will be motivated to commit tax fraud by trying to circumvent the tax code or false statement fraud by falsifying financial statements to artificially inflate the value of the business for a more prosperous exit.

Situational Risk Factors are risk factors associated with the business' environment and operations. Fraud examiners are looking to see if there is ample opportunity for fraud to happen. The following are situational risk factors that may be present in a cannabis business

- **Cash-intensive business:** Cash-intensive businesses have an increased risk of cash frauds such as cash larceny (theft) schemes and skimming schemes where cash is removed from the business before it hits the books. If employees are paid in cash, there is the opportunity for ghost employee schemes, false hours and wages schemes, and payroll tax evasion schemes.

³⁰ IRS, "Audit Techniques Guides(ATGs)," irs.gov.

³¹ Ibid.

³² Ibid.

- **Exposure to the underground economy:** Because cannabis businesses are cash-intensive and are subjected to extreme federal income tax burden, the risk of diversion and inversion is increased.
- **The use of a non-industry bookkeeper or accountant:** Using a bookkeeper or accountant that is not trained in the cannabis space will increase a business' risk of tax fraud schemes. Even if there is no intent to evade taxes, using accounting professionals who are not experts in cannabis tax codes, cannabis cost accounting, and proper vertical-specific accounting, will increase a business' risk of IRS-imposed penalties and fees, and/or additional tax owed due to adjustments made by the IRS.
- **Inadequate or poor internal controls:** Having inadequate or poor internal controls opens a business up to a wide range of fraud schemes including larceny, skimming, fraudulent disbursements, inventory schemes, bribery, conflicts of interest, money laundering, and extortion.

Behavioral Risk Factors are risk factors pertaining to the company's culture. Fraud examiners look to see if there is a company culture that embraces high tolerance of risk or unethical behavior. Cannabis CEOs are, by necessity, high-risk tolerant. Cannabis companies themselves exist in a legally ambiguous environment. The nature of the cannabis space itself automatically increases fraud risk.

Step 2: Observation of Affirmative Indicators

The IRS considers the situational risk factor of being cash intensive as significant, as is apparent by the dedication of an entire Audit Techniques Guide to cash-intensive businesses. The following excerpt highlights the risk factor and details indicators the investigator should watch for:

The most significant indicator that income has been underreported is a consistent pattern of losses or low profit percentages that seem insufficient to sustain the business or its owners. Other indicators of unreported income include:

- A life style [*sic*] or cost of living that can't be supported by the income reported.
- A business that continues to operate despite losses year after year, with no apparent solution to correct the situation.
- A Cash T shows a deficit of funds.
- Bank balances, debit card balances and liquid investments increase annually despite reporting of low net profits or losses.
- Accumulated assets increase even though the reported net profits are low or a loss.
- Debt balances decrease, remain relatively low or don't increase, but low profits or losses are reported.
- A significant difference between the taxpayer's gross profit margin and that of their industry.
- Unusually low annual sales for the type of business.

If an examiner wants to find income, they must actively look for income... hidden income is harder to find and requires a proactive approach. Examination techniques must be tailored to provide for the best analysis of a specific taxpayer's possible income stream.

There are several techniques that can be used successfully when working with cash intensive businesses. First, a financial status analysis including both business and personal financial activities should be done. This is a required minimum income probe.

Indirect methods, such as a fully developed Cash T can then be used to confirm the amount of any understatement.

... prohibition of the use of Financial Status Audit Techniques to determine the existence of unreported income unless a reasonable indication that Page 3 of 8 there is a likelihood of unreported income has been established. A reasonable likelihood can be established with the initial unresolved financial status analysis (T account).³³

Recognizing and Developing Fraud

Fraud investigators must understand the difference between affirmative acts and affirmative indicators. Affirmative indicators are not deemed compelling in and of themselves but are considered badges of fraud, red flags, symptoms, or signs of potentially fraudulent conduct.

Fraud Development Procedures³⁴

When indicators (badges) of fraud are uncovered, the compliance employee must clearly document the potential fraud indicators and initiate a discussion with the compliance employee's group manager. If the compliance employee's group manager concurs there are indicators of fraud warranting fraud development, the compliance employee must contact the fraud enforcement advisor (FEA).

After reviewing the potential fraud indicators and possible barriers to a successful referral, if the compliance employee, compliance employee's group manager and FEA agree the potential for fraud exists, the compliance employee must prepare Form 11661, Fraud Development Recommendation – Examination, or Form 11661-A, Fraud Development Recommendation – Collection, and forward the completed form to the compliance employee's group manager for approval.

The compliance employee must request the original tax returns, if not already secured. The compliance employee proceeds with the plan until affirmative acts of fraud are established or a determination is made that the potential for fraud no longer exists.

If affirmative acts of fraud are established, the FEA recommends a referral to Criminal Investigation (CI), if criminal criteria are met (see IRM 25.1.3, Criminal Referrals).

³³ IRS, "Cash Intensive Business (ATG)," Ch. 1, pp. 2-4.

³⁴ IRS, "IRM Fraud Handbook," 25.1.2.2.

Indicators of Fraud

Listed below are categories of fraud indicators. Each category list is not intended to be all-inclusive, instead citing examples of actions taxpayers may take to deceive or defraud.³⁵ Some of these indicators will be present before the initial interview with the taxpayer and can be used to demonstrate predication, others will not be observed until contact is made with the taxpayer and will be used to further develop and justify the fraud case.

- **Treatment of Income**³⁶
 - Omitting specific items where similar items are included.
 - Omitting entire sources of income.
 - Failing to report or explain substantial amounts of income identified as received.
 - Inability to explain substantial increases in net worth, especially over a period of years.
 - Substantial personal expenditures exceeding reported resources.
 - Inability to explain sources of bank deposits substantially exceeding reported income.
 - Concealing domestic or foreign bank accounts, brokerage accounts, digital assets such as virtual currency or other property.
 - Inadequately explaining dealings in large sums of currency, or the unexplained expenditure of currency.
 - Consistent concealment of unexplained currency, especially in a business not routinely requiring large cash transactions.
 - Failing to deposit receipts in a business account, contrary to established practices.
 - Failing to file a tax return, especially for a period of several years, despite evidence of receipt of substantial amounts of taxable income.
 - Cashing checks, representing income, at check cashing services and at banks where the taxpayer does not maintain an account.
 - Concealing sources of receipts by false description of the source(s) of disclosed income, and/or nontaxable receipts.

- **Treatment of Expenses and Deductions**³⁷
 - Claiming fictitious or substantially overstated deductions.
 - Claiming substantial business expense deductions for personal expenditures.
 - Claiming dependency exemptions for nonexistent, deceased, or self-supporting persons. Providing false or altered documents, such as birth certificates, lease documents, school/medical records, for the purpose of claiming the education credit, additional child tax credit, earned income tax credit (EITC), or other refundable credits.
 - Disguising trust fund loans as expenses or deductions.

- **Treatment of the Books and Records**³⁸
 - Multiple sets of books or no records.

³⁵ Ibid, 25.1.2.3.

³⁶ Ibid.

³⁷ Ibid.

³⁸ Ibid.

- Failure to keep adequate records, concealment of records, or refusal to make records available.
 - False entries, or alterations made on the books and records; back-dated or post-dated documents; false invoices, false applications, false statements, or other false documents or applications.
 - Invoices are irregularly numbered, unnumbered or altered.
 - Checks made payable to third parties that are endorsed back to the taxpayer. Checks made payable to vendors and other business payees that are cashed by the taxpayer.
 - Variances between treatment of questionable items as reflected on the tax return, and representations within the books.
 - Intentional under- or over-footing of columns in journal or ledger.
 - Amounts on tax return not in agreement with amounts in books.
 - Amounts posted to ledger accounts not in agreement with source books or records.
 - Journalizing questionable items out of correct account.
 - Recording income items in suspense or asset accounts.
 - False receipts to donors by exempt organizations.
- **Allocations of Income**³⁹
 - Distribution of profits to fictitious partners.
 - Inclusion of income or deductions in the tax return of a related taxpayer, when tax rate differences are a factor.
- **Conduct and Actions of the Taxpayer**⁴⁰
 - False statement about a material fact pertaining to the examination.
 - Attempt to hinder or obstruct the examination. For example, failure to answer questions; repeated cancelled or rescheduled appointments; refusal to provide records; threatening potential witnesses, including the examiner; or assaulting the examiner.
 - Failure to follow the advice of accountant, attorney or return preparer.
 - Failure to make full disclosure of relevant facts to the accountant, attorney or return preparer.
 - The taxpayer's knowledge of taxes and business practices where numerous questionable items appear on the tax returns.
 - Testimony of employees concerning irregular business practices by the taxpayer.
 - Destruction of books and records, especially if just after examination was started.
 - Transfer of assets for purposes of concealment, or diversion of funds and/or assets by officials or trustees.
 - Pattern of consistent failure over several years to report income fully.
 - Proof that the tax return was incorrect to such an extent and in respect to items of such magnitude and character as to compel the conclusion that the falsity was known and deliberate.
 - Payment of improper expenses by or for officials or trustees.
 - Willful and intentional failure to execute pension plan amendments.
 - Backdated applications and related documents.
 - False statements on Tax Exempt/Government Entity (TE/GE) determination letter applications.

³⁹ Ibid.

⁴⁰ Ibid.

- Use of false social security numbers.
 - Submission of false Form W-4.
 - Submission of a false affidavit.
 - Attempt to bribe the examiner.
 - Submission of tax returns with false claims of withholding (Form 1099-OID, Form W-2) or refundable credits (Form 4136, Form 2439) resulting in a substantial refund.
 - Intentional submission of a bad check resulting in erroneous refunds and releases of liens.
 - Submission of false Form W-7 information to secure Individual Taxpayer Identification Number (ITIN) for self and dependents.
- **Methods of Concealment⁴¹**
 - Inadequacy of consideration.
 - Insolvency of transferor.
 - Asset ownership placed in other names.
 - Transfer of all or nearly all of debtor's property.
 - Close relationship between parties to the transfer.
 - Transfer made in anticipation of a tax assessment or while the investigation of a deficiency is pending.
 - A concealed interest in the property transferred.
 - Transaction not in the usual course of business.
 - Retention of possession or continued use of asset.
 - Transactions surrounded by secrecy.
 - False entries in books of transferor or transferee.
 - Unusual disposition of the consideration received for the property.
 - Use of secret bank accounts for income.
 - Deposits into bank accounts under nominee names.
 - Conduct of business transactions in false names.

Step 3: Determine if Predication Exists

Predication

Predication is usually defined as the totality of circumstances that would lead a reasonable, professionally trained, and prudent individual to believe that a fraud has occurred, is occurring, or is about to occur. By law, predication must exist before a fraud investigation can occur. Suspicion in the absence of any corroborating circumstantial evidence is not a sufficient basis to meet the predication threshold for conducting a fraud examination.

⁴¹ Ibid.

Pre-Contact Analysis of the Tax Return

The IRS will perform a pre-audit review of a business's tax return and/or personal tax return to try to determine if there is sufficient evidence to warrant an investigation. Before the taxpayer is notified that they are under investigation, examiners will perform various financial analyses on the tax returns.

Fraud examiners employ several techniques to change plain, unconnected numbers into informative data to interpret a business' financial position. Investigating relationships between data within a company and comparing these relationships with other industries or businesses within the same industry, gives investigators better insight into a company's financial condition and points out the most likely areas where fraudulent data may be hidden within the financial statements.

Financial analysis techniques can help investigators discover and examine unexpected relationships in financial information. These analytical procedures are based on the premise that relatively stable relationships exist among economic events in the absence of conditions to the contrary. Known contrary conditions that cause unstable relationships to exist might include unusual or nonrecurring transactions or events, and accounting, environmental, or technological changes.

Unexpected deviations in relationships most likely indicate errors, but also might indicate illegal acts or fraud. Therefore, deviations in expected relationships warrant further investigation to determine the exact cause. Several methods of analysis assist the investigator in highlighting the areas that most likely represent fraudulent accounting methods. Analytical procedures are used to detect and examine relationships of financial information that do not appear reasonable.

According to the IRS, "Regardless of what techniques the examiner employs to examine a return, a thorough pre-audit analysis is essential to discover potential audit adjustments and fraudulent situations. The beginning of any examination is a pre-contact analysis, which is a review of the tax return to identify potential issues and data needed to plan the examination. The analysis should cover all aspects of the return."⁴² The Guide continues to discuss "Conducting the Minimum Income Probes"⁴³

The minimum income probes are analytical tests intended to determine whether the taxpayer accurately reported income. The use of the minimum income probes can establish whether there is unreported income.

If the taxpayer is underreporting income, the probes should result in the identification of at least some of the understatement. The examiner should try to maximize what can be discovered during the minimum income probes. If an indirect method will be needed it would be best to make the decision as quickly into the examination as possible.

Certain minimum probes will be made regardless of the type of return filed by the taxpayer. The minimum income probes for individual business returns are:

- Financial Status Analysis (Cash-T)

⁴² IRS, "Cash Intensive Business (ATG)," Ch. 2, p. 2.

⁴³ Ibid, Ch. 4, p. 3.

- Interview the Taxpayer
- Tour the Business
- Evaluate Internal Controls
- Reconcile Income to Books
- Test gross receipts
- Analyze Bank Accounts
- Analyze Business Ratios
- Test Gross Receipts
- Analyze Personal and Business Bank Accounts
- Analyze Business Ratios vs. Industry
- Using Financial Status Audit Techniques

Only some of the minimum probes identified by the Audit Techniques Guide can be conducted before contacting the taxpayer and will be discussed in this section. Others will be discussed in later sections.

- **Cash-T Account Analysis**

The IRS instructs, “Examiners must develop an estimated Cash T and/or source and application of funds in the preplan stage of the examination to get an idea of the taxpayer’s finances. The analysis will be more thoroughly developed as the examination progresses and more information is obtained.”⁴⁴ This analysis is identified as a Required Minimum Income Probe and:

is the development of a preliminary Cash-T analysis based on the tax return and case file information for individual business filers (Schedule C or F). This preliminary Cash-T is not a financial status audit technique (FSAT); it is simply a method of presenting the information and facilitating the analysis. For corporations and other business entities, examiners should prepare a comparative analysis of the balance sheet and income statements using the year under audit and the prior/subsequent year data.

If the preliminary analysis indicates that there is no material imbalance, then the depth of the examination can be limited to the Minimum Income Probes.

However, if the analysis indicates a significant imbalance in cash flows, tell the taxpayer (or representative) that there is an issue and give them a chance to explain or resolve the material imbalance. Show the taxpayer (or representative) how the analysis was completed and give them copies of relevant work papers for their review. To the extent possible, the taxpayer’s exact response to the Cash-T imbalance should be recorded.⁴⁵

⁴⁴ Ibid, Ch. 2, p.4.

⁴⁵ Ibid, Ch. 4, p. 3.

Cash-T Example:

The purpose of the “Cash-T” account analysis is to determine if the money spent by an individual is more than what is reasonable based on the tax returns.

The technique uses numbers from the taxpayer’s tax return to demonstrate that money held or controlled by the taxpayer came from unknown sources. In the following example, the examiner suspects that a taxpayer has unreported revenue from illegal cannabis oil sales other than the amount reported on the Schedule C sold to a licensed dispensary. The tax return for this example can be found in Appendix A, with all dollar amounts used highlighted in yellow.

Looking at the example on the next page, the first column lists the cash items included in the analysis, and the next two columns list the source that was used: the tax form and the line number on the form. For each cash item listed, the examiner enters the amount from the line on the tax form onto the Cash-T analysis worksheet in one of the two columns on the right under “Cash”. If the item is a source of cash to the taxpayer, it is listed in the “Sources” column. If the cash item represents cash spent (used), that amount is listed in the “Uses” column. It is important to note that “cash” consists of all liquid sources of money including checks, wire transfers, EFTs, virtual currency, etc., not just physical currency, and the Cash-T analysis is not a re-computation of the taxpayer’s tax return, therefore only certain values from the tax return are used in the analysis.

The first step in performing the Cash-T analysis is to identify sources of income. Form 1040, Line 1, lists wages reported of \$12,000, and this is listed in the Sources column on the Cash-T analysis worksheet. Since these are wages paid to the employee, taxes were withheld, and assuming the Form W-2 is not available, the employee portion of Social Security and Medicare taxes is estimated by multiplying the amount of wages by the tax amount for that year. In the example, the \$12,000 in wages multiplied by 6.2% yields an estimated \$744 in Social Security taxes paid from the wages. This is a usage of cash and is therefore listed under the Uses column on the Cash-T worksheet. The same is done for Medicare taxes at a rate of 1.45%, or \$174. The last item in the income section is interest paid out to the taxpayer in the amount of \$100, found on Line 2 on the Form 1040, and listed in the Sources column of the Cash-T worksheet. Since the examiner is only looking for sources of cash, the other amounts listed on the first page of the 1040 must be examined closer, in the schedules and forms from where they were calculated.

The next section of the Cash-T analysis deals with adjustments to income. By examining Schedule 1 of the tax return, the examiner discovers that they taxpayer spent \$2,000 for self-employed health insurance (line 17) and contributed \$3,000 to an IRA (line 20). These are both items that the taxpayer spent out-of-pocket, so they are listed in the Uses column on the Cash-T.

The next section lists all of the federal income tax payments that the taxpayer made during the tax year. Federal income taxes withheld are considered use of cash, because the employer withheld the taxes from the employee’s (taxpayer’s) paychecks and periodically paid them over to the IRS on the employee’s behalf, in effect, spending the taxpayer’s cash. Line 25 of the Form 1040 shows that \$1,800 was withheld on the taxpayer’s Form W-2, and this amount is listed under the Uses column on the Cash-T.

Cash T Account Analysis (Cash-T) Example

Item	Source		Cash	
	Tax Form	Line	Sources	Uses
Income:				
Wages	1040	1	12,000	
Social Security (6.2%)	Estimated			744
Medicare (1.45%)	Estimated			174
Interest	1040	2	100	
Adjustments to Income:				
Health Insurance	Sch 1	17		2,000
IRA	Sch 1	20		3,000
Tax Payments:				
Taxes Withheld	1040	25		1,800
Itemized Deductions:				
Medical	Sch A	1		3,500
Taxes Paid	Sch A	7		1,350
Interest Paid	Sch A	10		6,000
Gifts to Charity	Sch A	14		750
Job Expenses	Sch A	16		650
Profit or Loss From Business:				
Income - Gross Receipts	Sch C	1	45,000	
Purchases	Sch C	36		15,000
Materials and Supplies	Sch C	38		250
Advertising	Sch C	8		250
Repairs and Maintenance	Sch C	21		750
Meals and Entertainment	Sch C	24b		250
Meals and Entertainment - Excluded	Estimated			250
Other	Sch C	27a		865
Capital Gains and Losses:				
Sales Price - Long-Term	Sch D	8a	2,000	
Other:				
Education Credits	8863	8		1,000
Business Asset Purchase	4562	6b		15,000
Estimated Cash Activities			59,100	53,583
Estimated Available Cash				5,517

Next, the examiner inspects the Schedule A and lists all of the cash paid out. Line 1 shows \$3,500 was paid out-of-pocket for medical and dental expenses. Line 7 indicates \$1,350 in state and local taxes were paid. Line 10 shows \$6,000 in total interest was paid. Line 14 shows the taxpayer made cash gifts to charity in the amount of \$750, and line 16 indicates that the taxpayer paid \$650 in job expenses. All of these amounts are listed under the Uses column on the Cash-T.

The taxpayer in this example has reported two distinct sources of income: (1) W-2 wages paid by an employer, and (2) self-employment income from manufacturing “medicinal and botanical oils,” reported on a Schedule C, Profit or Loss From Business. At this point, the examiner has no way of knowing what type of oil the taxpayer manufactures. It could be something as innocuous as rose hip and mint oils, or even hemp oils, but the examiner suspects that it is high-THC cannabis oils, and that diversion is occurring.

Moving to the Schedule C, the examiner now adds the total gross sales from the business in the amount of \$45,000 to the Sources column on the Cash-T analysis worksheet. Next, cost of goods expenditures of \$15,000 in manufacturing purchases on line 36 and \$250 in manufacturing materials and supplies from line 38 are entered in the Uses column on the Cash-T. Ordinary expenses are then added to the Uses column on the Cash-T in the amount of \$250 for advertising (line 8), \$750 for repairs and maintenance (line 21), and \$250 in deductible meals and entertainment expenses (line 24b). Because only 50% of meals and entertainment is allowed as a deduction, the taxpayer actually paid out an additional \$250 in excluded meals and entertainment expense, and this is captured on the Cash-T, as well. The last item recorded from the Schedule C is other expenses in the amount of \$865 on line 27a. Looking down to line 48, the \$865 is associated with telephone expenses. Depreciation on line 13 is not added to the Cash-T since it does not necessarily represent an outlay of cash. Further investigation of the Form 4562 is necessary to determine which portion of the depreciation expense, if any, represents capital outlay. Business use of the home expense is also not included, since it does not represent cash paid out. It is also important to note her that if the taxpayer is, in fact, manufacturing and selling federally-illegal high THC cannabis oils, only the cost of goods expenses are allowed as deductions, and the other \$17,115 in ordinary business expenses claimed on the Schedule C will be disallowed upon audit (as per 26 US Code § 280E), and the taxpayer will be responsible for additional tax on that income, as well as possible penalties and interest.

Next, the examiner inspects the Schedule D and learns that the taxpayer received \$2,000 in proceeds from the sales of long-term assets. Even though the gain on the sale was only \$200, the full \$2,000 is recorded on the Cash-T as a Source of cash, since that is the amount that actually went into the taxpayer’s wallet, not just the \$200 in gain.

The final section lists other cash items from Forms 8863 and 4562 included in the tax return. On Form 8863, the taxpayer calculated an education credit of \$1,000 on line 8. Line 27 shows qualified educational expenses of at least \$4,000, but without knowing how much was covered by grants and scholarships, only the \$1,000 is added to the Cash-T as educational expenses paid out-of-pocket. Form 4562, Depreciation and Amortization, shows that the taxpayer purchased extraction equipment in the amount of \$15,000, and that amount is listed in the Uses column on the Cash-T analysis.

Now that the examiner has identified all cash items on the tax return, both the Cash Sources and Cash Uses columns on the Cash-T analysis are totaled at the bottom, and Uses is subtracted from Sources showing an estimated available cash amount of \$5,517 for the taxpayer to spend on all other normal living expenses for the entire year. Since the taxpayer listed their filing status as “single,” and did not indicate that someone else can claim them as a dependent because they provided material support, the taxpayer must be getting cash from another source to be able to afford a mortgage payment (indicated by the tax return), food, gas, etc.

The Cash-T analysis alone raises enough questions for the examiner to continue with further analysis of the tax returns, and possibly provides predication to request or subpoena the taxpayer’s bank records to look for additional deposits that exceed the total income listed on the tax return in order to identify the suspected unreported and potentially illegal income.

- **Percentage Analysis – Vertical and Horizontal**

There are traditionally two methods of percentage analysis of financial statements: vertical analysis and horizontal analysis. *Vertical analysis* is a technique for analyzing the relationships between the items on any one of the financial statements in one reporting period. The analysis results in the relationships between components expressed as percentages that can then be compared across periods. This method is often referred to as “common sizing” financial statements. In the vertical analysis of an income statement, net sales is assigned 100 percent; for a balance sheet, total assets is assigned 100 percent on the asset side, and total liabilities and equity is expressed as 100 percent on the other side. All other items in each of the sections are expressed as a percentage of these numbers.

Horizontal analysis is a technique for analyzing the percentage change in individual financial statement items from one year to the next. The first period in the analysis is considered the base, and the changes in the subsequent period are computed as a percentage of the base period. If more than two periods are presented, each period’s changes are computed as a percentage of the preceding period. The resulting percentages are then studied in detail. It is important to consider the amount of change as well as the percentage in horizontal comparisons. A 5 percent change in an account with a very large dollar amount may actually be much more of a change than a 50 percent change in an account with much less activity. Like vertical analysis, this technique does not detect small, immaterial frauds. However, both methods translate changes into percentages, which can then be compared to highlight areas of top concern.

The following is an example of financial statements that are analyzed by both vertical and horizontal analysis. It is important to note that a trend cannot be identified with less than three years of comparable values; ideally, an analyst would prefer a minimum of five years of data, and this is a simplified version for purposes of example only. This poses a challenge for the large segment of small businesses in the cannabis space that are just starting out and do not have five, or even three, years of financial data. That, compounded with the fact that cannabis businesses

usually experience exponential growth, makes it difficult to accurately analyze year-to-year change. The IRS also specifically mentions the following:⁴⁶

Analysis of Ending Inventory Balances:

$(\text{ENDING INV} - \text{BEGINNING INV}) \div \text{BEGINNING INVENTORY} = \text{the PERCENTAGE OF INCREASE OR DECREASE in Inventory}$

The examiner should make this calculation for the prior, current and subsequent years. This measures the amount of inventory increase (positive number) or decrease (negative number) over

the prior year. Inventory increases should result in higher sales. If sales have not increased correspondingly, the examiner should consider inventory items withdrawn by the owner for personal use.

Change in Net Sales from Year to Year:

$(\text{SALES in 2008 (from tax return)} - \text{SALES 2007 (from tax return)}) \div \text{SALES 2007 (from tax return)} = \text{the PERCENTAGE OF CHANGE in Net Sales from Year to Year.}$

This calculation shows how much sales increased or decreased from 2007 to 2008. If sales increased, the examiner should see a favorable Inventory Turnover Ratio and a corresponding increase in Change to Cost of Goods Sold. If sales increased and the expected changes are not present, sales are not reported or inventory may be a problem.

Change in Cost of Sales from Year to Year:

$(\text{COGS 2008 (from tax return)} - \text{COGS 2007 (from tax return)}) \div \text{COGS 2007 (from tax return)} = \text{the PERCENTAGE OF CHANGE in Cost of Sales from Year to Year.}$

If sales increased, the percentage of change to COGS should be consistent. Otherwise, inventory is understated.

⁴⁶ Ibid, Ch. 2, pp. 9-10.

Percentage Analysis Example

BALANCE SHEET	<i>Vertical Analysis</i>				<i>Horizontal Analysis</i>	
	<u>Year One</u>		<u>Year Two</u>		<u>Change</u>	<u>% Change</u>
ASSETS						
Current Assets						
Cash	45,000	14%	15,000	4%	(30,000)	-67%
Accounts Receivable	150,000	45%	200,000	47%	50,000	33%
Inventory	<u>75,000</u>	23%	<u>150,000</u>	35%	<u>75,000</u>	<u>100%</u>
Total Current Assets	270,000	82%	365,000	86%	95,000	35%
Fixed Assets, net	<u>60,000</u>	18%	<u>60,000</u>	14%	-	0%
TOTAL ASSETS	<u><u>330,000</u></u>	100%	<u><u>425,000</u></u>	100%	<u><u>95,000</u></u>	<u><u>29%</u></u>
LIABILITIES & EQUITY						
Liabilities						
Current Liabilities						
Accounts Payable	<u>95,000</u>	29%	<u>215,000</u>	51%	<u>120,000</u>	126%
Total Current Liabilities	95,000	29%	215,000	51%	120,000	126%
Long-Term Liabilities						
Long-Term Debt	<u>60,000</u>	18%	<u>60,000</u>	14%	-	0%
Total Long-Term Liabilities	<u>60,000</u>	18%	<u>60,000</u>	14%	-	0%
Total Liabilities	155,000	47%	275,000	65%	120,000	77%
Stockholders' Equity						
Common Stock	25,000	8%	25,000	6%	-	0%
Paid-In Capital	75,000	23%	75,000	18%	-	0%
Retained Earnings	<u>75,000</u>	23%	<u>50,000</u>	12%	<u>(25,000)</u>	-33%
Total Stockholders' Equity	<u>175,000</u>	53%	<u>150,000</u>	35%	<u>(25,000)</u>	-14%
TOTAL LIABILITIES & EQUITY	<u><u>330,000</u></u>	100%	<u><u>425,000</u></u>	100%	<u><u>95,000</u></u>	<u><u>29%</u></u>
INCOME STATEMENT						
	<i>Vertical Analysis</i>				<i>Horizontal Analysis</i>	
	<u>Year One</u>		<u>Year Two</u>		<u>Change</u>	<u>% Change</u>
Net Sales	250,000	100%	450,000	100%	200,000	80%
Cost of Goods Sold	<u>125,000</u>	50%	<u>300,000</u>	67%	<u>175,000</u>	140%
Gross Profit	125,000	50%	150,000	33%	25,000	20%
Operating Expenses						
Selling Expenses	50,000	20%	75,000	17%	25,000	50%
Administrative Expenses	<u>60,000</u>	24%	<u>100,000</u>	22%	<u>40,000</u>	67%
Total Operating Expenses	<u>110,000</u>	44%	<u>175,000</u>	39%	<u>65,000</u>	59%
Net Income	<u>15,000</u>	6%	<u>(25,000)</u>	-6%	<u>(40,000)</u>	-267%

- **Financial Ratio Analysis**

Ratio analysis is a means of measuring the relationship between two different financial statement amounts. Ratios are calculated from current year numbers and are then compared to previous years, other companies, the industry, or even the economy to judge the performance of the company. This form of financial statement analysis can be very useful in detecting red flags for a fraud examination. Many other professionals, including bankers, investors, business owners, and investment analysts, also use this method to better understand a company's financial health.

Ratio analysis allows for internal evaluations using financial statement data. The relationship and comparison are the keys to the analysis. For further insight, financial statement ratios are used in comparisons to an entity's industry averages. The IRS only mentions this briefly, with the following guidance:

Analyze Business Ratios vs. Industry

Analyze business ratios and compare to industry averages to evaluate the reasonableness of the taxpayer's reported business. If there are differences, ask the taxpayer why and write down the reply.⁴⁷

Industry Ratios

Bizstats.com offers free business statistics and financial ratios, by type of entity (sole proprietor, corporation, partnership), by industry (retail, beverage store, construction, etc.) and by amount of gross receipts. By entering the amount of gross receipts from the return into the Bizstats customized P&L report for the proper industry, Bizstats will prepare a benchmark vertical analysis that can be compared to the tax return. This analysis will tell the examiner how the business under audit compares with the industry as a whole. This does not indicate there is unreported income, but may raise some questions about the expenses that should be asked of the taxpayer.⁴⁸

If the IRS standard procedure is to have its examiners use the third-party commercial site Bizstats for industry benchmarking, this method of benchmarking is completely irrelevant to the cannabis industry. Bizstats compiles its benchmarking data based on NAICS⁴⁹ codes, and currently there are no codes specific to the cannabis industry. In this situation, taxpayers use their judgement to select a code that most closely represents their business, which they then report on their tax returns. IRS examiners will most likely use the code reported by the taxpayer for the benchmarking, but since taxpayers have no industry-specific codes, the results would not compare the business to a representative sample and would therefore, be statistically irrelevant and another method should be developed until codes are established.

⁴⁷ Ibid, Ch. 4, p. 9.

⁴⁸ Ibid, Ch. 2, p. 8.

⁴⁹ North American Industry Classification System, U.S. Census Bureau. NAICS is the standard used by Federal statistical agencies in classifying businesses for the purpose of collecting, analyzing, and publishing data related to the U.S. business economy.

Benchmarking aside, if the financial ratios present a significant change from one year to the next, or over a period of years, there might be a problem. As in all other analyses, specific changes are often explained by changes in the business operations. When a change in a specific ratio or several related ratios is detected, the appropriate source accounts should be researched and examined in detail to determine if fraud has occurred. For instance, a significant decrease in a company's current ratio might point to an increase in current liabilities or a reduction in assets, both of which could be used to cover fraud. When used for fraud detection and investigation, the CHANGES in the ratios over time are more important in analysis than ACTUAL SIZE of the ratio. An account or ratio, say Accounts Receivable, that is growing or shrinking at unrealistic rates would be a red flag, indicating further investigation may be necessary.

In the analysis of financial ratios, each investigator will determine which ratios are most important. As with the vertical analysis discussed previously, the analysis of ratios is limited by its inability to detect fraud on a smaller, immaterial scale.

These ratios may also reveal frauds other than accounting frauds. If an employee is embezzling from the company's accounts, for instance, the amount of cash will decrease disproportionately and the current ratio will decline. Liability concealment will cause a more favorable ratio. Similarly, a check-tampering scheme will usually result in a decrease in current assets, namely cash, which will, in turn, decrease the current ratio. In fact, these frauds might be more easily detected with ratio analysis because employees other than management would not have access to accounting cover-ups of non-accounting frauds. Anomalies in ratios could point directly to the existence of fraudulent actions. Accounting frauds can be much more subtle and demand extensive investigation beyond the signal that something is out of the norm.

The following calculations are based on the financial statement example presented earlier:

Common Fraud Investigation Ratios	
Ratio	Computation
Current Ratio	<i>Current Assets / Current Liabilities</i>
Quick Ratio	<i>(Cash + Securities + Receivables) / Current Liabilities</i>
Debt-to-Equity Ratio	<i>Total Liabilities / Total Equity</i>
Profit Margin Ratio	<i>Net Income / Net Sales</i>
Gross Profit Margin Ratio	<i>Gross Profit / Net Sales</i>
Receivables Turnover Ratio	<i>Net Sales on Account / Average Net Receivables</i>
Collection Ratio	<i>365 Days / Receivable Turnover</i>
Inventory Turnover Ratio	<i>Cost of Goods Sold / Average Inventory</i>
Inventory Days-in-Stock Ratio	<i>365 Days / Inventory Turnover</i>
Asset Turnover Ratio	<i>Net Sales / Average Assets</i>

Because these ratios are being computed during the Pre-Contact Analysis phase, the data for the ratios to be computed must be gathered from the tax returns alone. The chart below shows the location of each data point needed:

Ratio Component	Location on Tax Return (Form 1120)	
	Line Number(s)*	Line Description
Net Sales	1c	Balance
Cost of Goods Sold	2	Cost of goods sold
Gross Profit	3	Gross profit
Net Income	30	Taxable Income
Cash	L - 1	Cash
Beginning Net A/R	L - 2a(a) plus L - 2b(a)	Trade notes and accounts receivable Less allowances for bad debts
Ending Net A/R	L - 2a(c) plus L - 2b(c)	Trade notes and accounts receivable Less allowances for bad debts
Beginning Inventory	L - 3(b)	Inventories
Ending Inventory	L - 3(d)	Inventories
Total Current Assets	L - 1(d) plus L - 2(d) plus L - 3(d) plus L - 4(d) plus L - 5(d) plus L - 6 d)	Cash A/R less allowance for bad debts Inventories U.S. government obligations Tax-exempt securities Other current assets
Beginning Total Assets	L - 15(b)	Total assets
Ending Total Assets	L - 15(d)	Total assets
Total Current Liabilities	L - 16(d) plus L - 17(d) plus L - 18(d)	Accounts payable Mortgages, notes, bonds payable in less than 1 year Other current liabilities
Total Liabilities	L - 16(d) plus L - 17(d) plus L - 18(d) plus	Accounts payable Mortgages, notes, bonds payable in less than 1 year Other current liabilities

	L – 19(d) plus L – 20(d) plus L – 21(d)	Loans from shareholders Mortgages, notes, bonds payable in 1 year or more Other liabilities
Total Stockholders' Equity	L – 28(d) less L – 16(d) less L – 17(d) less L – 18(d) less L – 19(d) less L – 20(d) less L – 21(d)	Total liabilities and shareholders' equity Accounts payable Mortgages, notes, bonds payable in less than 1 year Other current liabilities Loans from shareholders Mortgages, notes, bonds payable in 1 year or more Other liabilities

*L refers to Schedule L of Form 1120.

After collection of the required data, the following ratios can then be computed:

Financial Ratio Analysis Example			
	<u>Year One</u>	<u>Year Two</u>	
<i>Additional Information for Computation:</i>			
Average Net Receivables	155,000	210,000	
Average Inventory	65,000	130,000	
Average Assets	330,000	425,000	
Current Ratio	2.84	1.70	
Quick Ratio	2.05	1.00	
Debt-to-Equity Ratio	0.89	1.83	
Profit Margin Ratio	6%	-6%	Calculated in Vertical Analysis
Gross Profit Margin Ratio	50%	33%	Calculated in Vertical Analysis
Receivables Turnover Ratio	1.61	2.14	
Collection Ratio	226.30	170.33	
Inventory Turnover Ratio	1.92	2.31	
Inventory Days-in-Stock Ratio	189.80	158.17	
Asset Turnover Ratio	0.76	1.06	

- **Current Ratio**

Current Assets / Current Liabilities

The current ratio, current assets divided by current liabilities, is probably the most frequently used ratio in financial statement analysis. This comparison measures a company's ability to meet short-term obligations from its liquid assets. The number of times that current assets exceed current liabilities has long been a measure of financial strength.

In detecting fraud, this ratio can be a prime indicator of manipulation of accounts involved. Embezzlement will cause the ratio to decrease. Liability concealment will cause a more favorable ratio.

In the preceding example, the drastic change in the current ratio from year one (2.84) to year two (1.70) should cause a fraud examiner to look at these accounts in more detail. For instance, a check-tampering scheme will usually result in a decrease in current assets, or cash, which will, in turn, decrease the ratio.

- **Quick Ratio**

(Cash + Securities + Receivables) / Current Liabilities

The quick ratio, often referred to as the acid-test ratio, compares assets that can be immediately liquidated to liabilities that will be due in the next year. This calculation divides the total cash, securities, and receivables by current liabilities. This ratio is a measure of a company's ability to meet sudden cash requirements. In turbulent economic times, it is used quite prevalently, giving the analyst a worst-case look at the company's working capital situation.

A fraud examiner analyzes this ratio for fraud indicators. In year one of the example, the company balance sheet reflects a quick ratio of 2.05. This ratio drops in year two to 1.00. In this situation, a closer review of accounts receivable shows that they are increasing at an unusual rate, which could indicate that fictitious accounts receivable have been added to inflate sales. Of more concern, perhaps, is the increase in accounts payable that might require, at a minimum, a closer review to determine why. If the drop in the ratio indicates a problem customer or a significant slowing in the time to collection, it might reflect a general decline in company prospects. That, in turn, would be a red flag that management could feel pressured to report fraudulent financials.

- **Debt-to-Income Ratio**

Total Liabilities / Total Equity

The debt-to-equity ratio is computed by dividing total liabilities by total equity. It indicates the proportion of equity and debt a company uses to finance its assets. Because the ratio provides a picture of the relative risk assumed by the creditors and owners, it is heavily considered by lending institutions. The higher the ratio, the more difficult it will be for the owners to raise capital by increasing long-term debt, and the greater the risk assumed by creditors. Debt-to-equity requirements are often included as borrowing covenants in corporate lending

agreements. The example displays a year one ratio of 0.89. This is very favorable, as it shows that the company is financed more by equity than by debt.

However, year two shows a ratio of 1.83, meaning that debt is greatly increasing relative to equity. In this case, the increase in the ratio corresponds with the rise in accounts payable. Sudden changes in this ratio may signal a fraud examiner to look for fraud.

- **Profit Margin Ratio**

Net Income / Net Sales

The profit margin ratio is net income divided by sales. This ratio is often referred to as the efficiency ratio, in that it reveals profits earned per dollar of sales. This percentage of net income to sales examines not only the effects of gross margin changes, but also changes in selling and administrative expenses. If fraud is committed, net income may be artificially overstated, resulting in a profit margin ratio that is abnormally high compared to other periods. False expenses cause an increase in expenses and a decrease in the profit margin ratio. This ratio should be fairly consistent over time.

In this example, the profit margin analysis is already calculated in the vertical and horizontal analyses. While revenues increased by 80 percent, the cost of goods sold increased by 140 percent; this, in turn, dropped profit margins from 6 percent to -6 percent. Further investigation could uncover fraudulent accounting that shifted costs from one period to another, or might reveal another type of fraud in which inventory is being stolen so costs appear to jump.

- **Gross Profit Margin Ratio**

The gross profit margin ratio represents the percentage markup on the cost of merchandise sold and measures how well the company manages its cost of sales. The higher the ratio, the better. Gross profit represents value added to the business. For gross profit to exist, the company must be able to buy goods (cost of sales), add value, and then sell them to customers for an amount greater than their original costs. In the previous example, the gross profit margin for year one was 50%. To translate, for every \$1.00 of sales, the company earned \$0.50 in profit, which will then be used to cover operating costs. The IRS mentions this ratio specifically:

Gross Profit Margin or Percentage:

$$\text{GROSS PROFIT ON SALES (from tax return)} \div \text{SALES (from tax return)} \\ = \text{GROSS PROFIT PERCENTAGE}$$

The examiner should make this calculation for the prior, current and subsequent years. Is there significant change between years? If so, tailor the interview-ask how the business was doing, if any changes were made. A drop

in the gross profit percentage can mean sales are not recorded or money is not in register.⁵⁰

- **Receivables Turnover Ratio**

Net Sales on Account / Average Net Receivables

Receivable turnover is defined as net sales on account divided by average net receivables. It measures the number of times the receivables balance is turned over during the accounting period. In other words, it measures the time between sales on account and the collection of funds. This ratio is one that uses both income statement and balance sheet accounts in its analysis. If fictitious sales have been recorded, this bogus income will never be collected. As a result, the turnover of receivables will decrease.

If the fraud is caused from fictitious sales, this bogus income will never be collected. In the example, the accounts receivable turnover jumps from 1.61 to 2.14. The fraud examiner can use this ratio as an indicator that revenues might be fake, thus requiring further examination of source documents.

- **Collection Ratio**

365 Days / Receivable Turnover

Accounts receivable aging is measured by the collection ratio, which divides 365 days by the receivable turnover ratio to arrive at the average number of days to collect receivables. In general, the lower the collection ratio, the faster receivables are collected.

A fraud examiner may use this ratio as a first step in detecting fictitious receivables or larceny and skimming schemes. Normally, this ratio stays fairly consistent from year to year, but changes in billing policies or collection efforts may cause a fluctuation. The example shows a favorable reduction in the collection ratio from 226.3 in year one to 170.33 in year two. This means that the company is collecting its receivables more quickly in year two than in year one.

- **Inventory Turnover Ratio**

Cost of Goods Sold / Average Inventory

The relationship between a company's cost of goods sold and its average inventory is shown through the inventory turnover ratio. This ratio measures the number of times the inventory is sold during the period. This ratio is a good determinant of purchasing, production, and sales efficiency. In general, a higher inventory turnover ratio is considered more favorable.

For example, if cost of goods sold has increased due to theft of inventory (ending inventory has declined, but not through sales), then this ratio will be abnormally high. In the case example, inventory turnover increases in year two, signaling the possibility that an embezzlement is buried in the inventory account. A fraud examiner should look at the changes

⁵⁰ Ibid, Ch. 2., p. 9.

in the components of the ratio to determine a direction in which to discover possible fraud. This is the other ratio that the IRS mentions specifically:

Inventory Turnover:

$$\text{COST OF GOODS SOLD (from tax return)} \div (\text{BEGINNING} + \text{ENDING INV}) / 2 = \text{the TIMES INVENTORY TURNED OVER PER YEAR}$$

When turnover increases, the business is more profitable because items are sold faster, making room for new items to be sold. Compare the Inventory Turnover from the prior, current and subsequent years. If turnover increases you should see a corresponding increase in Gross Margin (sales). If one ratio is increased but the other isn't, ending inventory may be understated.

Businesses maintain inventory so they will have on hand the items their customers want. A business only makes money when the inventory sells or "turns over", and the higher the turnover rate, the higher the profits.

A ratio analysis of inventory in relation to sales can show the true picture when no records are provided. A ratio analysis can also be used to find inconsistencies in the reporting.⁵¹

- **Inventory Days-in-Stock Ratio**

365 Days / Inventory Turnover

The average-number-of-days-inventory-is-in-stock ratio is a restatement of the inventory turnover ratio expressed in days. This rate is important for several reasons. An increase in the number of days that inventory stays in stock causes additional expenses, including storage costs, risk of inventory obsolescence, and market price reductions, as well as interest and other expenses incurred due to tying up funds in inventory stock. Inconsistency or significant variance in this ratio is a red flag for fraud investigators. Fraud examiners may use this ratio to examine inventory accounts for possible larceny schemes. Purchasing and receiving inventory schemes can affect the ratio. Understating the cost of goods sold results in an increase in the ratio as well. Significant changes in the inventory turnover ratio are good indicators of possible fraudulent inventory activity.

- **Asset Turnover Ratio**

Net Sales / Average Assets

Net sales divided by average operating assets is the calculation used to determine the asset turnover ratio. This ratio measures the efficiency with which asset resources are used. The case example above displays a greater use of assets in year two than in year one.

⁵¹ Ibid.

Step 4: Perform the Investigation

Once the pre-contact analysis of the taxpayer's returns has been completed and the examiner determines that enough affirmative indicators, along with substantive corroborating evidence, exist to meet the predication threshold, the investigation can begin. It is at this time that the taxpayer is contacted and first becomes aware that they are under investigation.

Tour of the Business

The first thing an examiner will want to do is tour the business to get an understanding of how the business operates, to observe processes, and to visually inspect the facilities. This is a requirement of the IRS as Required Minimum Income Probes:

Tour the Business

Have the taxpayer explain how the business operates, including each process.

For each process, document each step, especially the handling of cash, from its receipt to the time it leaves the business.

Observe the type of payments that are made and how they are handled. Spend some time watching the procedures at the register and stay long enough to observe several transactions.⁵²

Evaluate Internal Controls

An evaluation of the taxpayer's internal controls will determine the reliability of the books and records.

Internal controls are the taxpayer's policies and procedures to identify, measure, and safeguard business operations to avoid material misstatements of financial information. The purpose in analyzing internal controls is to (1) understand and document the entire business operation and (2) determine if the books and records are reliable and adequately reflect business operations.⁵³

Initial Interview of the Taxpayer

After touring the business, the examiner will sit down with the taxpayer for an interview during which time the examiner will ask questions, review documents, and perform tests on the books and records. These are all Required Minimum Income Probes.

The initial interview of the taxpayer sets the stage for the rest of the examination. The primary purpose of the interview is to secure, by conversation with the taxpayer, facts which will present the taxpayer's overall financial picture, an understanding of the

⁵² Ibid, Ch.4, p. 5.

⁵³ Ibid, Ch. 5, p. 6.

operations, and an overview of the recordkeeping practices (that is, type of records maintained and the accounting controls).

In a cash intensive business there may be very few tangible records, so it is important to perform a detailed and meticulous interview. The oral testimony of the taxpayer at this point may turn out to be the only evidence provided, so it must be exhaustive enough to be properly evaluated. The smallest detail gathered may be useful later when no records can be found. The examiner should not abbreviate the interview. A proper interview for a cash intensive business may take two or more hours, so be sure to offer the taxpayer a short break.

Have the taxpayer explain every step from the time cash and other income is received until it is deposited to a bank or spent. Only by taking the time to write down every step in the cash process and noting the name of every person who handles cash, can an examiner find weaknesses in the system if they exist. Don't hesitate to ask candid questions about how cash is handled or how money is spent for both business and personal reasons.⁵⁴

Examiners should use the interview to gain an understanding of the business process and judge the credibility of the taxpayer.⁵⁵

- **Examining Business Processes**

The examiner will usually start by asking questions to get a better understanding of the historical and current finances of the business and also how specific processes are conducted.

Business History

Develop data relating to the taxpayer's business history and related businesses. Does the taxpayer own controlling interests in multiple businesses or is he/she a partner? Secure information about accounts receivable, loans receivable, inventories, and a general statement of how the inventories are valued and method used. Ask that a record of the inventory be made available.

If a comparative analysis shows losses or consistently low profits, ask the taxpayer what has caused the problem and what is being done to improve the situation. The taxpayer will be knowledgeable about the industry and can explain any market fluctuations. Remember, no one will remain in a business that does not earn profits.⁵⁶

⁵⁴ Ibid, Ch. 3, p. 2.

⁵⁵ Ibid, Ch. 4, p. 4.

⁵⁶ Ibid, Ch. 3, p. 3.

Financial Information

Inquire about commingling of business bank accounts and personal accounts of the immediate family. Be specific about all open or closed accounts-business, personal, savings, certificates of deposit, and other forms of money deposits.

Request detailed information about bank loans, personal loans, accounts payable, and other borrowed funds. It may be more practical to cover loans made outside the business, which do not appear in the regular books.

Determine whether the taxpayer received any nontaxable income such as gifts, inheritances, or proceeds from life insurance. Determine the taxpayer's security holdings in stocks, bonds and mutual funds. Obtain a listing of the real estate holdings. Be specific about the personal residence and monthly payments.

Ask about other assets ... those that appear on the return and those that do not.

Sources of income: Is there any other income, which the taxpayer considered not reportable?

Non-taxable income: a gift, inheritances, loans, and other non-taxable sources should be tied down as closely as possible early in the audit.⁵⁷

Accounting for Cash

Ask the taxpayer to explain the mechanics of how cash is handled in the business. It is important during the interview to have the taxpayer explain every step of cash handling, beginning with the collection of gross receipts from every source. Prepare a flow chart of the cash flow from the time it is received until it is placed into a third party's hands and ask the taxpayer if the flow chart is correct. Include the name of every individual who has contact with the cash at every point. This can later be compared to the CBRS data for accuracy or to determine the credibility of the interview.

Then a similar explanation must be solicited for cash that is paid out as expenditures, including who is authorized to pay cash and where the cash comes from. Write down the taxpayer's exact responses whenever possible.

The examiner must understand the accounting systems used and determine who is responsible for maintaining each type of record.⁵⁸

Cash on Hand

Examiners must ask about cash-on-hand that the taxpayer has access to, including funds available from friends or relatives.

⁵⁷ Ibid, p. 4.

⁵⁸ Ibid, p. 2.

Since Cash on Hand and Accumulated Funds are important fundamental aspects of the examination of income and the formal indirect methods, examiners should establish the amount and verify the taxpayer's statements of cash accumulations during the initial interview. This is necessary because:

Cash on Hand and Accumulated Funds can explain Financial Status Analyses that appear to identify a potentially significant imbalance. The issue can be resolved quickly and with the least amount of burden to the taxpayer if it is addressed early in the examination.

The information is needed to determine whether a formal indirect method should be used, and which method is most appropriate.

An adjustment for unreported income can be challenged if the availability of Cash on Hand and Accumulated Funds is not addressed at the beginning of the audit. The after-the-fact [*sic*] "cash in the mattress"• defense cannot be used if the actual Cash on Hand and Accumulated Funds have already been established.⁵⁹

- **Follow-Up of Pre-Contact Analysis Findings**

Once the examiner asks initial interview questions, more specific questions will be asked to clarify the results of the pre-contact analyses. This is the first opportunity that the taxpayer will have to explain any anomalies identified.

Financial Status Analysis (Cash-T)

... if the analysis indicates a significant imbalance in cash flows, tell the taxpayer (or representative) that there is an issue and give them a chance to explain or resolve the material imbalance. Show the taxpayer (or representative) how the analysis was completed and give them copies of relevant work papers for their review. To the extent possible, the taxpayer's exact response to the Cash-T imbalance should be recorded.⁶⁰

Analyze Business Ratios

The books and records should always be used to evaluate the accuracy and reasonableness of the reported amount of income through the use of ratios.

Example: Analyzed Gross Profit Percentage, Inventory Turnover and Percentage Change in Inventory. GPP decreased significantly in 2006 from a consistent 59-61% to 32%. At the same time inventory turnover (a factor of sales) increased from 278% to 459%. This indicates more items were sold in 2006, but less profit was earned. In the following year GPP rose to 43% and inventory turnover that had increased to 459% dipped back to 297%. 2006 is anomalous and the income/inventory figures do not appear to be correct. Need an explanation for this situation.⁶¹

⁵⁹ Ibid, p. 3

⁶⁰ Ibid, Ch. 4, p. 3.

⁶¹ Ibid, p. 8.

Analyze business ratios and compare to industry averages to evaluate the reasonableness of the taxpayer's reported business. If there are differences, ask the taxpayer why and write down the reply.⁶²

- **Testing Income and Expenses**

The examiner will then perform tests on the books and records to check for completeness, accuracy, and timing of transactions, and to also look for anomalies that could be indicators of fraud.

Reconcile Income to Books

Reconcile the income reported on the tax return to the taxpayer's books and records. Ask the taxpayer how income was computed and duplicate the taxpayer's steps.⁶³

Test gross receipts

After reconciling the income to the books, test the income that is included in the books by tying the original source documents (cash register receipts and/or invoices) to the amount reported.

When the original records that would trace to the books are missing, for whatever reason, further testing must be done. The examiner may try to match an expense item to verify the corresponding income is reported. Or, an indirect method of calculating income must be used.⁶⁴

Test Gross Receipts

If there are excessive cash register shortages, investigate the explanations for each individual shortage. Follow up by speaking with the employee who used the register. If the employee is no longer with the business, it may be worthwhile to locate the individual and ask about procedures at the business.

For a sample period, match cash reported to be received (less cash paid out for that day or days) on the daily sheet to the amount deposited. If no daily sheet is maintained, match one day's Ztape [*sic*] cash (Z-tape total - check and credit payments = cash sales; ask the taxpayer to calculate checks and credit payments) to the bank deposit. Ask the taxpayer to explain any discrepancy.⁶⁵

The examiner can expect to see the summary Z tapes and the detail X tapes (if a cash register is used), sales invoices or receipts (if no cash register is used), daily reconciliation sheets, monthly sales sheets (that will match the Statement of Profits and Losses) and bank deposit detail. Any deviation from these elementary steps

⁶² Ibid, p. 9.

⁶³ Ibid, p. 6.

⁶⁴ Ibid, p. 7.

⁶⁵ Ibid, p. 9.

should be recorded by the examiner and may indicate a disregard for recordkeeping rules and a lack of internal controls.⁶⁶

Techniques to Corroborate or Refute Income Related Items

Various audit and investigative techniques are available to corroborate or refute a taxpayer's claim about his or her business operations or nature of doing business. The following are illustrations of audit or investigative techniques for a cash intensive business:

An Examiner determines that a large understatement of income could exist based on return information and other sources of information that are in the case file. Interview questions are formulated based on the preliminary Cash-T information, and, at the initial interview, the taxpayer responds that no loans or gifts were received nor was a cash hoard maintained. No explanation was given for the difference in cash flows. After many repeated inquiries, the taxpayer responds that the amounts are from loans and gifts from relatives who live out of the country. (Remember that the taxpayer operates a cash business.) The books and records are poor. The taxpayer has no records to support the claim that the amounts are loans or gifts, except a copy of a letter from a relative stating that the relative gave the amounts at issue. (Sometimes the taxpayer's proof is only oral testimony.) The amounts at issue could be from unreported income from the cash intensive business.⁶⁷

Evaluate the Initial Facts Concerning the Non-Taxable Sources and the Current Status of the Audit

The examiner must get specific information from the taxpayer.

If the taxpayer cannot provide specific information the examiner should question the credibility of the statements.

Specific dates and amounts are important.

If the taxpayer cannot provide specific amounts and dates of the currency received, they cannot know the understatement is not attributable to gross receipts.⁶⁸

Examination Techniques for a Cash Business

Since many businesses in this industry are cash oriented, have weak internal controls, lack an audit trail, and have inadequate books and records, the examiner's audit should focus on probing for unreported income.

The most likely method for a cash intensive business that does not report their full income is to skim cash prior to its entry in the accounting system. This can be done by failing to deposit all of the funds, by failing to use a cash register to record

⁶⁶ Ibid, Ch. 1, p. 7.

⁶⁷ Ibid, Ch. 6, p. 2.

⁶⁸ Ibid.

sales or by failing to report an income stream. The result is that the books will reconcile to the return and the bank deposits, but income will be missing. Skimming can be discovered through excess expenditures or when markup percentages are corrected.⁶⁹

Purchases Can Reveal Sales

A quick first step is to look for a purchase that will reveal sales. Once the examiner knows the correct number of items sold, either the taxpayer can produce the missing data or sales can be determined by multiplying the number by the average of the reported sales.⁷⁰

Sources

There are times when it is easier to find unreported income. Following are a few examples.

Selling the business - It is in the taxpayer's interest to give these sources the correct business information, first because the healthier the business the better price it will garner, but also because the potential buyer may be in the same business and will recognize problematic records.

Getting a loan – When a business is looking for funding or to expand, they will need to supply the lender with healthy financial statements.

Divorce – A disadvantaged spouse can attest to the amount of money flowing into the household by verifying what was spent. The spouse may also have knowledge of hidden assets or unidentified sources of income, such as sideline sales or another cash business.

Employees – especially mistreated employees can discuss business practices they have observed over time. They can say who handled cash and what procedures were overridden. Employees may also be able to prove they were paid in cash to avoid payroll taxes.⁷¹

- **Bank Account Examination**

Bank accounts are examined not only to reconcile to the books and records, but also to provide new leads when new transactions are discovered.

Analyze Bank Accounts

The examiner must review all accounts, business and personal, including investment accounts, CD accounts, savings account, etc.

⁶⁹ Ibid, Ch. 5, p. 2.

⁷⁰ Ibid.

⁷¹ Ibid, pp. 2-3.

The examiner should be concerned when the total deposits are less than the reported gross receipts. This can mean either business receipts are being spent instead of being deposited (for example, cash pay outs for the business or cash paid to the owner) or, the business receipts as reported are not accurate.

If the business expenditures paid by check are less than the deducted business expenses on the return, then the taxpayer may be overstating expenses, paying expenses by cash (unreported income), or paying expenses from an undisclosed source of funds.

One way to test the checks written is to compare all of the cancelled checks for a sample period, such as one month, by comparing the names of payees with that of each endorser. If they do not agree or if the name of any officer, partner or other related individual appears as an endorser find out why. While testing the written checks, verify each payment in the cash disbursement book or check register. If there are any discrepancies the examiner must inquire further. Be alert for any payees who are related individuals and for any checks written to cash.⁷²

Analyze Personal and Business Bank Accounts

Remember, businesses that deal in cash do not deposit all of their cash receipts into bank accounts; some cash is retained for use in the business.⁷³

Evaluating Evidence

After the examination is complete, additional analysis will be done in an effort to make a determination of whether fraud exists. These additional procedures are not done in front of the taxpayer. If additional information or clarification is needed during this phase, the examiner will reach out to the taxpayer again.

- **Inadequate Records**

During the examination with the taxpayer, the examiner makes notes throughout the process, paying special attention to the state of the taxpayer's books and records.

Inadequate Records

All taxpayers are required by law to maintain accounting records of sufficient detail to enable the proper preparation of a tax return. If it is determined that the taxpayer has failed to maintain adequate records, then the issuance of an Inadequate Records Notice should be considered. This serves to place taxpayers on notice that their record keeping practices are deficient and must be improved to meet the requirements of the law.

⁷² Ibid, Ch. 4, p. 9.

⁷³ Ibid.

An Inadequate Records Notice should be considered for a cash intensive business whenever:

- an adjustment is made using an indirect method (the existing records did not accurately reflect income)
- an adjustment is made and source documents, such as cash register tapes, receipts or invoices, were missing
- an adjustment is made and no books were maintained an adjustment is made because the taxpayer failed to disclose a source of income (for example, internet sales or another business)

The examiner will also discuss the situation with the taxpayer and explain in detail what needs to be done to correct the problem.

After completion of the examination, the examiner prepares letter 978 or 979 to notify the taxpayer.

It is very likely the taxpayer will be examined in the future to determine if the recordkeeping practices have improved.⁷⁴

Importance of Issuing a Summons

When the taxpayer does not have adequate books and records, the agent should make the decision early in the examination to summons third-party recordkeepers (attorneys, enrolled agents, banks, brokers, accountants, etc.) and other third parties, (suppliers, vendors, etc.) to produce records.

If the taxpayer does not have adequate books and records and the agent needs to summons bank records to complete an indirect method, it is important to issue a summons for all deposited items and checks for each of the known bank accounts. This is necessary to ensure a complete review and identification of documents providing substantiation of taxable or non-taxable income. The deposited items will also help prove that a taxable source exists for the deposits.

The revenue agent should also consider issuing a summons to an uncooperative taxpayer so that the taxpayer could be asked, at the summons hearing, whether he/she had any transfers of funds between the bank accounts that the revenue agent had not already uncovered. The uncooperative taxpayer can also be asked about any other potential sources of non-taxable income, such as the receipt of loans, gifts, or inheritances that were deposited. And, even if the taxpayer refuses to answer the examiner's questions, which information is helpful to demonstrate the revenue agent has tried to follow all reasonable leads.

⁷⁴ Ibid, Ch. 6, p. 11.

NOTE: Whenever the taxpayer's books and records are deemed inadequate for purposes of an examination of income, the examiner should consider the issuance of an inadequate records notice at the conclusion of the examination.⁷⁵

- **Further Financial Analysis**

Now that the examiner has obtained more information from the taxpayer's books and records, further and more in-depth analysis of the taxpayer's financial statements will be completed to determine if tax fraud exists, and if so, to what extent. Adjustments to the taxpayer's return(s) will also be made and penalties assessed, if warranted.

Using Financial Status Audit Techniques

Once an examiner has established that there is a reasonable likelihood of unreported income, a more in-depth examination of income is warranted. Examiners will need to decide which techniques are best suited for the individual taxpayer.⁷⁶

What penalties or additions to tax could a participant in the marijuana industry be subject to if adjustments are made during an income tax audit?

A participant in the marijuana industry is subject to the same penalties and additions to tax as any other business. A non-exhaustive list of penalties and additions to tax that might apply include: additions to tax under 6651 if a return is filed late or payments are made late; a penalty for failure to make estimated tax payments if sufficient estimated tax payments are not made; accuracy related penalties; and, in cases of fraud, penalties under section 6663. See generally *Alternative Health Care Advocates v. Commissioner*, 151 T.C. 225 (2018).⁷⁷

Will penalties under section 6662 be proposed if an audit ends with the IRS proposing adjustments for a participant in the marijuana industry?

Penalties will be considered on a case by case [*sic*] basis. The Tax Court has previously upheld a negligence penalty under section 6662 where a participant in the marijuana industry failed to keep adequate books and records. See *Olive v. Commissioner*, 139 T.C. 19 (2012), *aff'd*, 792 F.3d 1146 (9th Cir. 2015). The Tax Court more recently upheld section 6662 penalties when petitioners did not prove they had reasonable cause for significant omissions of income on their returns. *Alternative Health Care Advocates v. Commissioner*, 151 T.C. 225 (2018); *Richmond Patients Group v. Commissioner*, T.C. Memo. 2020-52.

⁷⁵ *Ibid*, Ch. 3, p. 6.

⁷⁶ *Ibid*, Ch. 4, p. 10.

⁷⁷ IRS, "Marijuana Industry Frequently Asked Questions," [irs.gov](https://www.irs.gov).

Step 5: Determine if Affirmative Acts are Present

If affirmative indicators are still present and there is substantive evidence to support fraud, the examiner now looks for affirmative acts in order to further develop the case.

Fraud Considerations

Taxpayers who knowingly understate their tax liability often leave evidence in the form of identifying earmarks (or indicators). Fraud indicators can consist of one or more acts of intentional wrongdoing on the part of the taxpayer with the specific purpose of evading tax. Fraud indicators may be divided into two categories: affirmative indications or affirmative acts. No fraud can be found in any case unless affirmative acts are present.

Affirmative indications serve as a sign or symptom, or signify that actions may have been done for the purpose of deceit, concealment or to make things seem other than what they are. Indications in and of themselves do not establish that a particular process was done; affirmative acts also need to be present. Examples of affirmative indications include:

- substantial unexplained increases in net worth,
- substantial excess of personal expenditures over available resources,
- bank deposits from unexplained sources substantially exceeding reported income
- inadequate books and records
- conduct that is evasive, misleading or uncooperative

Affirmative acts are those actions that establish that a particular process was deliberately done for the purpose of deceit, subterfuge, camouflage, concealment, some attempt to color or obscure events, or make things seem other than what they are. Examples include:

- omissions of specific items where similar items are included,
- concealment of bank accounts or other property,
- the use of nominees on bank accounts or other property
- failure to deposit receipts to business accounts
- hiding sources of receipts
- destruction of records

Fraud is generally defined as deception, misrepresentation of material facts, or silence when good faith requires expression.

Elements common to all tax fraud cases include an understatement of tax liability, willful intent to evade taxes and a course of action demonstrating the taxpayer's intent.

1. Presence of Fraud

Fraud implies bad faith on the part of a taxpayer, shown by acts calculated to cheat, mislead, or conceal. This can include the destruction or concealment of records relating to an income source.

2. Elements of Fraud – The Government is required to prove:

- a. A significant understatement of tax liability.
- b. Willfulness – an act of commission, or omission, requiring:
 1. Knowledge – consider education, experience, and participation in the acts.
 2. Intent – implied from words and action of the taxpayer.
 3. Evil Purposes – A dishonest intent to conceal or misrepresent.

3. Consideration for the Agent

- a. Identify all bank accounts.
- b. Issue summons as needed.
- c. Ask taxpayer for explanation of understatement.
- d. Refute or verify the taxpayer's explanation.
- e. Expand the examination to multiple years or related entities.
- f. Consider the preparer's involvement.
- g. Contact third parties as needed.
- h. Identify a likely source of income.
- i. In an altered documents case, show that the expenses are fictitious.
- j. Show harm to the government
- k. Consider additional expenses that go along with unreported income.

If the examiner suspects a potentially fraudulent situation, either civil or criminal, they will discuss the case with their manager as soon as possible. If the group manager concurs, the fraud technical advisor (FTA) will immediately be contacted and both the group manager and FTA will provide guidance on how to proceed.⁷⁸

When affirmative acts (firm indications) of fraud/willfulness exist and criminal criteria are met, the compliance employee will refer the case through the Fraud Enforcement Advisor (FEA) to Criminal Investigation (CI) via Form 2797, Referral Report of Potential Criminal Fraud Cases.⁷⁹

Conducting a Criminal Investigation

Once an investigation is opened, the special agent obtains the facts and evidence needed to establish the elements of criminal activity. Various investigative techniques are used to obtain evidence, including interviews of third party witnesses, conducting surveillance, executing search warrants, subpoenaing bank records, and reviewing financial data.

⁷⁸ Ibid, Ch. 6, pp. 12-14.

⁷⁹ IRS, "IRM Fraud Handbook," 25.1.1.2(4).

The special agent works closely with IRS Chief Counsel Criminal Tax Attorneys during the course of the criminal investigation. This process ensures all legal aspects of the investigation and prosecution recommendation are correctly addressed.⁸⁰

Step 6: Finding of Tax Evasion

“Generally, for fraud to be considered, the compliance employee must show: (a) an additional tax due and owing as the result of a deliberate intent to evade tax; and (b) the willful and material submission of false statements or false documents in connection with an application and/or return.”⁸¹

Criminal Violations

Tax Fraud (Tax Evasion) is a criminal offence and is prosecutable under 26 U.S.C. § 7201:

26 US Code § 7201 - Attempt to evade or defeat tax

Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.⁸²

Aiding and Abetting also a criminal offense and is prosecutable under 26 U.S.C. § 7206(2):

It is important to determine who is responsible for the fraudulent act(s). If it is determined that the taxpayer is not the responsible party, then consideration should be given to determine if other related parties such as the preparer can be held responsible.

Civil penalties apply to anyone who aids and abets an understatement of tax liability under IRC 6701. An individual who willfully aids and assists with the understatement of a tax liability can be criminally charged under Title 26 USC 7206(2). The individual must be directly involved in the preparation or presentation of the false or fraudulent document. This may include independent parties such as lawyers, accountants, return preparers, and appraisers who counsel on a course of action. It is possible for criminal referrals and/or civil penalties to apply to both the taxpayer and the person assisting the taxpayer.⁸³

26 U.S. Code § 7206 - Fraud and false statements

⁸⁰ IRS, “How Criminal Investigations are Initiated,” irs.gov.

⁸¹ IRS, “IRM Fraud Handbook,” 25.1.1.2(6).

⁸² I.R.C. § 7201.

⁸³ IRS, “IRM Fraud Handbook,” 25.1.2.5.

(2) Aid or assistance

Willfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document⁸⁴

A more complete list of criminal violations can be found in Appendix B.

Prosecution

“After all the evidence is gathered and analyzed, the special agent and his or her supervisor either make the determination that evidence does not substantiate criminal activity, in which case the investigation is 'discontinued,' or the evidence is sufficient to support the recommendation of prosecution, in which case the agent proceeds with the preparation of a written report detailing the findings of violation of the law and recommending prosecution.”⁸⁵

This report is called a "special agent report" and it is reviewed by numerous officials, including:

1. The agent's front line supervisor, called the supervisory special agent;
2. A criminal investigation quality review team, Centralized Case Review;
3. CI assistant special agent in charge;
4. CI special agent in charge.

If CI determines the investigation should be criminally prosecuted, a prosecution recommendation is forwarded to:

1. The Department of Justice, Tax Division, (if it is a tax investigation) or
2. The United States Attorney for all other investigations.

Each level of review may determine that evidence does not substantiate criminal charges and the investigation should not be prosecuted.⁸⁶

If the Department of Justice or the United States Attorney accepts the investigation for prosecution, the IRS special agent will be asked by the prosecutors to assist in preparation for trial. However, once a special agent report is referred to for prosecution, the investigation is managed by the prosecutors.⁸⁷

⁸⁴ I.R.C. § 7206(2).

⁸⁵ IRS, "How Criminal Investigations are Initiated," irs.gov.

⁸⁶ Ibid.

⁸⁷ Ibid.

Taxpayer Defenses

Prosecutors will keep the following taxpayer defenses in mind, and will have proper rebuttals prepared:

- No taxes are due
- The scheme was set up to avoid rather than evade taxes owed
- Unpaid taxes are based on tax law, regulations, or prior court findings that no longer apply
- Mental incompetence or impaired capacity of the taxpayer
- Incompetence of paid bookkeeping services
- Ignorance of a complicated tax law
- Reliance on an accountant or attorney

Conviction

“The ultimate goal of an IRS Criminal Investigation prosecution recommendation is to obtain a conviction - either by a guilty verdict or plea. Approximately 3,000 criminal prosecutions per year provide a deterrent effect and signals to our compliant taxpayers that fraud will not be tolerated.”⁸⁸

I am proud to share the FY 2021 IRS Criminal Investigation Annual Report. The IRS, and our country, relies on CI’s ability to investigate and recommend prosecution of criminal tax violations and other related financial crimes to the Department of Justice. The deterrent effect from our work reinforces the backbone of our voluntary compliance tax system -- a system that funds our government, our military, and our infrastructure. Criminal tax cases that are prosecuted and publicized provide a strong deterrent message to would-be tax evaders, helping to ensure the integrity and fairness in the U.S. tax system. It also provides deterrence to those who are considering other financial crimes. Our efforts put criminals on notice – they will be caught when they commit these crimes.

- Jim Lee, Chief, Internal Revenue Service, Criminal Investigation (IRS-CI)⁸⁹

According to the IRS:CI Annual Report 2021, 1372 investigations were initiated, \$2.19 billion in tax fraud was identified, 850 prosecutions were recommended, and 633 offenders were sentenced. The IRS:CI had 2,046 Special Agents in 2021, who spent 72% of their investigative time on tax crimes, with an overall conviction rate of 89.4%.⁹⁰

⁸⁸ Ibid.

⁸⁹ IRS:CI, “Annual Report 2021,” [irs.gov](https://www.irs.gov).

⁹⁰ Ibid.

BEST PRACTICES FOR BUSINESSES IN THE CANNABIS SPACE

Although there are many financial problems in the cannabis space today, there are solutions for CEOs.

Assess the Situation

Before making any changes in the business, CEOs should take stock of their organization and decide what specific areas require remediation. This is also a good time to for CEOs to start seeking out expert professionals for guidance.

Understand and Become Compliant with Applicable Laws

The first step to compliance is determining jurisdiction. Every facility that belongs to a business has a location: county, state, and possibly a city. Each city, county, and state have their own laws and licensing requirements for businesses that operate within its jurisdiction, and each cannabis business is most likely subject to multiple jurisdictions. It is important to understand the licensing and other legal requirements of each, and then to obtain required licenses and permits.

Each jurisdiction may also levy a variety of other taxes such as sales taxes, cultivation taxes, and excise taxes. Registering to collect and pay over state and local taxes is mandatory, and businesses will be penalized for non-compliance. CEOs should consult with a cannabis accountant who understand the cannabis space and who stays abreast of the complex tax rules and constantly changing environment.

Understand How the IRS Applies the Tax Code

Understanding both the tax code itself *and* how the IRS applies it is crucial to compliance. Reading about relevant tax court cases and their outcomes, such as *CHAMP v. Commissioner*, *Olive v. Commissioner*, and *Harborside v. Commissioner*, will provide a solid foundation. Consulting with a cannabis tax accountant or a cannabis tax law attorney is recommended to clear up any confusion. Having a good working knowledge as to how the tax code is applied will help guide business decisions going forward.

Assess the Entity Structure

CEOs need to take a careful look at entity structure of their business to determine if it is efficient and compliant. While it is not illegal to have a complex, multi-entity business structure, it needs to be carefully examined to determine if it has a purpose other than avoiding tax. There also needs to be

real and substantive purpose for each separate entity. CEOs also need to be aware that certain entity structures, such as LLCs, allow tax liability to flow to them personally, and the IRS examiners will follow the tax liability to the CEO's personal tax returns. Consultation with a corporate attorney who is an expert in the cannabis space is highly recommended for help with entity structure.

Make Necessary Corrections

After assessing the state of the business and clearing up any immediate compliance issues mentioned above, it is recommended to make other corrections as necessary to bring the company into compliance and to provide protection if audited.

Clean Up Current Books and Records

The amount of cleanup of the books and records can vary greatly depending upon if the business is using the correct chart of accounts, and if it is not, the length of time transactions have been recorded using the incorrect chart of accounts. To be done correctly, a cleanup will entail the restructuring of the chart of accounts by a cannabis-expert accountant, and then the review of each transaction over an agreed-upon time frame (usually somewhere between one to two years), to determine the correct reclassification. These types of projects can be quite expensive, but are a bargain compared to the penalties, fees, and additional tax that could be owed with improper accounting.

During the cleanup process, personal expenses should be separated from business expenses, and all business expenses should also be reviewed to ensure the correct characterization of costs that might qualify as costs of goods sold.

It is recommended that after cleanup has been completed, a full financial analysis of the financial statements be performed by a qualified accountant or financial analyst. All the fraud-related financial ratios should be computed, especially those that may be used by the IRS, with explanations provided to the CEO in preparation for audit. If anomalies are detected, a forensic accountant should be consulted to further analyze the books, should the CEO suspect embezzlement, larceny, or other internal fraud schemes.

Strengthen Internal Controls

The most widely recognized way to deter or prevent fraud is by having a good system of controls. Good control activities involve policies that provide physical control of assets, proper authorizations, segregation of duties, independent check, and proper documentation. Having proper internal controls reduces scrutiny by outside authorities and helps to ensure the CEO is receiving the correct return on investment. There are many different internal controls and an infinite number of scenarios, therefore consultation with a qualified fraud prevention or compliance specialist knowledgeable in the cannabis space is highly recommended.

Prepare for the IRS Tour of Business

Cannabis CEOs should visit every business location, or designate qualified individuals to do so if the business is large, to look at the facility from an examiner's point of view. This is another area where a fraud prevention consultant could be quite helpful.

The involvement of legal counsel is also suggested to adequately prepare employees to properly cooperate with and assist the IRS examiners. Not only will this help with preparation, but can also, in certain circumstances, make discussions with employees subject to the attorney-client privilege.

Stay Ahead

Now that the cannabis business is in compliance, CEOs can stay ahead by focusing on staying ahead and avoiding any setbacks.

Concentrate on Building a Brand and Adding Value

This is where cannabis CEOs can add the most value to their businesses, using their entrepreneurial and creative skills, and leaving the details to qualified individuals.

Continue to Comply with Tax Codes

Even though CEOs have accounting and tax professionals handling the day-to-day activities and the tax returns, CEOs are still ultimately responsible for what goes on in their businesses and continual communication is crucial in this area.

Keep Current on Changes to the Law and What the IRS is Doing

Carefully follow U.S. Tax Court cases and other federal court rulings, Department of Treasury guidance and IRS bulletins and publications. Constitutional and other challenges to § 280E are ongoing and these challenges are unlikely to end soon.

Survive and Thrive

Cannabis CEOs did not get into business to fail. Although the cannabis industry presents unique challenges, cannabusinesses continue to survive and thrive in the space. Getting into compliance and

staying there is crucial to success and negotiating obstacles and properly positioning for exit can help CEOs realize their goals.

Survive the Audit

The most important thing for CEOs to do when they have been notified that their business has been identified for audit is to contact an experienced tax attorney, preferably one with knowledge of the cannabis industry. The IRS much prefers the initial contact with the taxpayer to be without counsel. An attorney can help explain direct discussions, identify applicable privileges, and set strategy.

That being said, it is extremely important to cooperate with the IRS examiner. If the examiner has to use legal means to compel the CEO to allow entry to the business, fines will be imposed. Make sure counsel is present at all meetings with IRS personnel, whether in person, over the telephone, or over the internet. Attorneys will be sure to protect the CEO's rights, including the right to invoke the Fifth Amendment, if and when it is necessary and appropriate.

All correspondence with the IRS should be in writing and should go through counsel. Not only does this provide physical evidence, but it can also be used to afford the taxpayer additional time to gather paperwork and consult with legal counsel.

Position the Business for Exit

CEOs need to engage a mergers and acquisitions (M&A) legal team long before they receive a letter of intent, as it generally takes at least six months to properly prepare for exit. M&A attorneys will make sure that books and records are in order, a valuation has been recently completed, intellectual property is protected, and all necessary contracts have been signed.

CEOs also need to be honest and transparent with their M&A attorneys and let them help address any weak spots before there is a buyer. If the buyer's accountants and attorneys find the issues first, this puts the selling CEO in a very defensive posture and lacking in negotiating power.

Large public companies want to buy leaders in their space, and that does not necessarily mean attractive financials. They are looking for companies whose products are at the top in their category or geographic area. This is why concentrating on value and not net income is so important.

Making sure books and records are in order and taxes have been computed correctly is extremely important when preparing for exit. If a business has been collecting taxes incorrectly for years, the business could potentially owe hundreds of thousands of dollars, which will be a very unpleasant surprise when the buyer opens up the books. Additionally, if a business' taxes are found to be done incorrectly under audit, the audit assessment could be so large that instead of closing a lucrative deal, the business will no longer have a buyer, and the CEO will end up going out of business due to the size of the tax liability incurred.

Even if exit is not in the immediate future, CEOs need to pay attention to the details that can set them up for a large offer later.

CONCLUSION

The cannabis space has major accounting issues with complicated taxes and accounting requirements, complex compliance issues, and a lack of access to cannabis-expert ancillary services. Businesses in the cannabis space also face tax burdens that erase enormous amounts of their profits and government agencies that specifically target their existence. Cannabusinesses also face an ever-changing landscape of regulation and political interference.

Despite all that, CEOs can survive, and even thrive, in the space by becoming familiar with what the IRS is looking for and how their examiners conduct investigations, making sure their books are rock-solid, and concentrating on adding value to their brand, to capitalize on the large exit opportunity when, and not if, it presents itself.

APPENDIX A

Tax Return for Cash-T Analysis Example

Filing Status Single Married filing jointly Married filing separately (MFS) Head of household (HOH) Qualifying widow(er) (QW)
 Check only one box. If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent ▶

Your first name and middle initial _____ Last name _____ **Your social security number**
Example Taxpayer 0 0 0 0 0 0 0 0 0
 If joint return, spouse's first name and middle initial _____ Last name _____ **Spouse's social security number**

Home address (number and street). If you have a P.O. box, see instructions. **123 Main Street** Apt. no. _____ **Presidential Election Campaign**
 City, town, or post office. If you have a foreign address, also complete spaces below. State **FL** ZIP code **00000** Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund.
Anytown Foreign country name _____ Foreign province/state/county _____ Foreign postal code _____ You Spouse

At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency? Yes No

Standard Deduction **Someone can claim:** You as a dependent Your spouse as a dependent Spouse itemizes on a separate return or you were a dual-status alien

Age/Blindness **You:** Were born before January 2, 1957 Are blind **Spouse:** Was born before January 2, 1957 Is blind

Dependents (see instructions):

If more than four dependents, see instructions and check here ▶ <input type="checkbox"/>	(1) First name		(2) Social security number	(3) Relationship to you	(4) <input checked="" type="checkbox"/> if qualifies for (see instructions):	
	Last name				Child tax credit	Credit for other dependents
					<input type="checkbox"/>	<input type="checkbox"/>
					<input type="checkbox"/>	<input type="checkbox"/>
					<input type="checkbox"/>	<input type="checkbox"/>
					<input type="checkbox"/>	<input type="checkbox"/>

Attach Sch. B if required.	1	Wages, salaries, tips, etc. Attach Form(s) W-2	1	12,000
	2a	Tax-exempt interest	2b	100
Standard Deduction for— • Single or Married filing separately, \$12,550 • Married filing jointly or Qualifying widow(er), \$25,100 • Head of household, \$18,800 • If you checked any box under Standard Deduction, see instructions.	3a	Qualified dividends	3b	C
	4a	IRA distributions	4b	C
	5a	Pensions and annuities	5b	C
	6a	Social security benefits	6b	C
	7	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ <input type="checkbox"/>	7	200
	8	Other income from Schedule 1, line 10	8	13,135
	9	Add lines 1, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your total income	9	25,435
	10	Adjustments to income from Schedule 1, line 26	10	5,928
	11	Subtract line 10 from line 9. This is your adjusted gross income	11	19,507
	12a	Standard deduction or itemized deductions (from Schedule A)	12a	12,500
	b	Charitable contributions if you take the standard deduction (see instructions)	12b	C
	c	Add lines 12a and 12b	12c	12,500
	13	Qualified business income deduction from Form 8995 or Form 8995-A	13	C
	14	Add lines 12c and 13	14	12,500
	15	Taxable income. Subtract line 14 from line 11. If zero or less, enter -0-	15	7,007

16	Tax (see instructions). Check if any from Form(s): 1 <input type="checkbox"/> 8814 2 <input type="checkbox"/> 4972 3 <input type="checkbox"/>	16	703
17	Amount from Schedule 2, line 3	17	C
18	Add lines 16 and 17	18	703
19	Nonrefundable child tax credit or credit for other dependents from Schedule 8812	19	C
20	Amount from Schedule 3, line 8	20	C
21	Add lines 19 and 20	21	C
22	Subtract line 21 from line 18. If zero or less, enter -0-	22	703
23	Other taxes, including self-employment tax, from Schedule 2, line 21	23	1,504
24	Add lines 22 and 23. This is your total tax	24	2,207
25	Federal income tax withheld from:		
a	Form(s) W-2	25a	1,800
b	Form(s) 1099	25b	C
c	Other forms (see instructions)	25c	C
d	Add lines 25a through 25c	25d	1,800
26	2021 estimated tax payments and amount applied from 2020 return	26	C
27a	Earned income credit (EIC)	27a	C
	Check here if you were born after January 1, 1998, and before January 2, 2004, and you satisfy all the other requirements for taxpayers who are at least age 18, to claim the EIC. See instructions <input type="checkbox"/>		
b	Nontaxable combat pay election	27b	C
c	Prior year (2019) earned income	27c	C
28	Refundable child tax credit or additional child tax credit from Schedule 8812	28	C
29	American opportunity credit from Form 8863, line 8	29	1,000
30	Recovery rebate credit. See instructions	30	C
31	Amount from Schedule 3, line 15	31	C
32	Add lines 27a and 28 through 31. These are your total other payments and refundable credits	32	1,000
33	Add lines 25d, 26, and 32. These are your total payments	33	2,800

If you have a qualifying child, attach Sch. EIC.

Refund

34	If line 33 is more than line 24, subtract line 24 from line 33. This is the amount you overpaid	34	593
35a	Amount of line 34 you want refunded to you . If Form 8888 is attached, check here <input type="checkbox"/>	35a	593
▶ b	Routing number 000000000 ▶ c Type: <input checked="" type="checkbox"/> Checking <input type="checkbox"/> Savings		
▶ d	Account number 00000000000000000000000000000000		
36	Amount of line 34 you want applied to your 2022 estimated tax	36	C

Amount You Owe

37	Amount you owe. Subtract line 33 from line 24. For details on how to pay, see instructions	37	
38	Estimated tax penalty (see instructions)	38	

Third Party Designee

Do you want to allow another person to discuss this return with the IRS? See instructions **Yes.** Complete below. **No**

Designee's name ▶ **Example Bookkeeper** Phone no. ▶ **(000) 000-0000** Personal identification number (PIN) ▶ **000000**

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature	Date	Your occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.) ▶
Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation	If the IRS sent your spouse an Identity Protection PIN, enter it here (see inst.) ▶
Phone no.	Email address		

Paid Preparer Use Only

Preparer's name	Preparer's signature	Date	PTIN	Check if: <input type="checkbox"/> Self-employed
Firm's name ▶	Firm's address ▶			Phone no.
Firm's address ▶	Firm's EIN ▶			

**SCHEDULE 1
(Form 1040)**

Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

▶ Attach to Form 1040, 1040-SR, or 1040-NR.
▶ Go to www.irs.gov/Form1040 for instructions and the latest information.

OMB No. 1545-0074

2021
Attachment
Sequence No. **01**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR

Your social security number

Example Taxpayer

000-00-0000

Part I Additional Income

1	Taxable refunds, credits, or offsets of state and local income taxes	1	c
2a	Alimony received	2a	c
b	Date of original divorce or separation agreement (see instructions) ▶ _____		
3	Business income or (loss). Attach Schedule C	3	13,135
4	Other gains or (losses). Attach Form 4797	4	c
5	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	5	c
6	Farm income or (loss). Attach Schedule F	6	c
7	Unemployment compensation	7	c
8	Other income:		
a	Net operating loss	8a (c)	
b	Gambling income	8b	c
c	Cancellation of debt	8c	c
d	Foreign earned income exclusion from Form 2555	8d (c)	
e	Taxable Health Savings Account distribution	8e	c
f	Alaska Permanent Fund dividends	8f	c
g	Jury duty pay	8g	c
h	Prizes and awards	8h	c
i	Activity not engaged in for profit income	8i	c
j	Stock options	8j	c
k	Income from the rental of personal property if you engaged in the rental for profit but were not in the business of renting such property	8k	c
l	Olympic and Paralympic medals and USOC prize money (see instructions)	8l	c
m	Section 951(a) inclusion (see instructions)	8m	c
n	Section 951A(a) inclusion (see instructions)	8n	c
o	Section 461(l) excess business loss adjustment	8o	c
p	Taxable distributions from an ABLÉ account (see instructions)	8p	c
z	Other income. List type and amount ▶ _____	8z	c
9	Total other income. Add lines 8a through 8z	9	c
10	Combine lines 1 through 7 and 9. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8	10	13,135

Part II Adjustments to Income

11	Educator expenses	11		c
12	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	12		c
13	Health savings account deduction. Attach Form 8889	13		c
14	Moving expenses for members of the Armed Forces. Attach Form 3903	14		c
15	Deductible part of self-employment tax. Attach Schedule SE	15		928
16	Self-employed SEP, SIMPLE, and qualified plans	16		c
17	Self-employed health insurance deduction	17		2,000
18	Penalty on early withdrawal of savings	18		c
19a	Alimony paid	19a		c
	b Recipient's SSN ▶ _____			
	c Date of original divorce or separation agreement (see instructions) ▶ _____			
20	IRA deduction	20		3,000
21	Student loan interest deduction	21		c
22	Reserved for future use	22		
23	Archer MSA deduction	23		c
24	Other adjustments:			
	a Jury duty pay (see instructions)	24a		c
	b Deductible expenses related to income reported on line 8k from the rental of personal property engaged in for profit	24b		c
	c Nontaxable amount of the value of Olympic and Paralympic medals and USOC prize money reported on line 8l	24c		c
	d Reforestation amortization and expenses	24d		c
	e Repayment of supplemental unemployment benefits under the Trade Act of 1974	24e		c
	f Contributions to section 501(c)(18)(D) pension plans	24f		c
	g Contributions by certain chaplains to section 403(b) plans	24g		c
	h Attorney fees and court costs for actions involving certain unlawful discrimination claims (see instructions)	24h		c
	i Attorney fees and court costs you paid in connection with an award from the IRS for information you provided that helped the IRS detect tax law violations	24i		c
	j Housing deduction from Form 2555	24j		c
	k Excess deductions of section 67(e) expenses from Schedule K-1 (Form 1041)	24k		c
	z Other adjustments. List type and amount ▶ _____	24z		c
25	Total other adjustments. Add lines 24a through 24z	25		c
26	Add lines 11 through 23 and 25. These are your adjustments to income . Enter here and on Form 1040 or 1040-SR, line 10, or Form 1040-NR, line 10a	26		5,928

**SCHEDULE 2
(Form 1040)**

Department of the Treasury
Internal Revenue Service

Additional Taxes

▶ Attach to Form 1040, 1040-SR, or 1040-NR.
▶ Go to www.irs.gov/Form1040 for instructions and the latest information.

OMB No. 1545-0074

2021
Attachment
Sequence No. **02**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR

Your social security number

Example Taxpayer

000-00-0000

Part I Tax

1	Alternative minimum tax. Attach Form 6251	1	c
2	Excess advance premium tax credit repayment. Attach Form 8962	2	c
3	Add lines 1 and 2. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 17	3	c

Part II Other Taxes

4	Self-employment tax. Attach Schedule SE	4	1,504
5	Social security and Medicare tax on unreported tip income. Attach Form 4137	5	c
6	Uncollected social security and Medicare tax on wages. Attach Form 8919	6	c
7	Total additional social security and Medicare tax. Add lines 5 and 6	7	c
8	Additional tax on IRAs or other tax-favored accounts. Attach Form 5329 if required	8	c
9	Household employment taxes. Attach Schedule H	9	c
10	Repayment of first-time homebuyer credit. Attach Form 5405 if required	10	c
11	Additional Medicare Tax. Attach Form 8959	11	c
12	Net investment income tax. Attach Form 8960	12	c
13	Uncollected social security and Medicare or RRTA tax on tips or group-term life insurance from Form W-2, box 12	13	c
14	Interest on tax due on installment income from the sale of certain residential lots and timeshares	14	c
15	Interest on the deferred tax on gain from certain installment sales with a sales price over \$150,000	15	c
16	Recapture of low-income housing credit. Attach Form 8611	16	c

(continued on page 2)

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 71478U

Schedule 2 (Form 1040) 2021

Part II Other Taxes *(continued)*

17	Other additional taxes:			
a	Recapture of other credits. List type, form number, and amount ► _____	17a		c
b	Recapture of federal mortgage subsidy. If you sold your home in 2021, see instructions	17b		c
c	Additional tax on HSA distributions. Attach Form 8889	17c		c
d	Additional tax on an HSA because you didn't remain an eligible individual. Attach Form 8889	17d		c
e	Additional tax on Archer MSA distributions. Attach Form 8853	17e		c
f	Additional tax on Medicare Advantage MSA distributions. Attach Form 8853	17f		c
g	Recapture of a charitable contribution deduction related to a fractional interest in tangible personal property	17g		c
h	Income you received from a nonqualified deferred compensation plan that fails to meet the requirements of section 409A	17h		c
i	Compensation you received from a nonqualified deferred compensation plan described in section 457A	17i		c
j	Section 72(m)(5) excess benefits tax	17j		c
k	Golden parachute payments	17k		c
l	Tax on accumulation distribution of trusts	17l		c
m	Excise tax on insider stock compensation from an expatriated corporation	17m		c
n	Look-back interest under section 167(g) or 460(b) from Form 8697 or 8866	17n		c
o	Tax on non-effectively connected income for any part of the year you were a nonresident alien from Form 1040-NR	17o		c
p	Any interest from Form 8621, line 16f, relating to distributions from, and dispositions of, stock of a section 1291 fund	17p		c
q	Any interest from Form 8621, line 24	17q		c
z	Any other taxes. List type and amount ► _____	17z		c
18	Total additional taxes. Add lines 17a through 17z	18		c
19	Additional tax from Schedule 8812	19		c
20	Section 965 net tax liability installment from Form 965-A	20		c
21	Add lines 4, 7 through 16, 18, and 19. These are your total other taxes . Enter here and on Form 1040 or 1040-SR, line 23, or Form 1040-NR, line 23b	21		1,504

**SCHEDULE 3
(Form 1040)**

Department of the Treasury
Internal Revenue Service

Additional Credits and Payments

▶ Attach to Form 1040, 1040-SR, or 1040-NR.
▶ Go to www.irs.gov/Form1040 for instructions and the latest information.

OMB No. 1545-0074

2021
Attachment
Sequence No. **03**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR

Your social security number

Example Taxpayer

000-00-0000

Part I Nonrefundable Credits

1	Foreign tax credit. Attach Form 1116 if required		1	c
2	Credit for child and dependent care expenses from Form 2441, line 11. Attach Form 2441		2	c
3	Education credits from Form 8863, line 19		3	c
4	Retirement savings contributions credit. Attach Form 8880		4	c
5	Residential energy credits. Attach Form 5695		5	c
6	Other nonrefundable credits:			
a	General business credit. Attach Form 3800	6a		c
b	Credit for prior year minimum tax. Attach Form 8801	6b		c
c	Adoption credit. Attach Form 8839	6c		c
d	Credit for the elderly or disabled. Attach Schedule R	6d		c
e	Alternative motor vehicle credit. Attach Form 8910	6e		c
f	Qualified plug-in motor vehicle credit. Attach Form 8936	6f		c
g	Mortgage interest credit. Attach Form 8396	6g		c
h	District of Columbia first-time homebuyer credit. Attach Form 8859	6h		c
i	Qualified electric vehicle credit. Attach Form 8834	6i		c
j	Alternative fuel vehicle refueling property credit. Attach Form 8911	6j		c
k	Credit to holders of tax credit bonds. Attach Form 8912	6k		c
l	Amount on Form 8978, line 14. See instructions	6l		c
z	Other nonrefundable credits. List type and amount ▶ _____	6z		c
7	Total other nonrefundable credits. Add lines 6a through 6z		7	c
8	Add lines 1 through 5 and 7. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 20		8	c

(continued on page 2)

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 71480G

Schedule 3 (Form 1040) 2021

Part II Other Payments and Refundable Credits

9	Net premium tax credit. Attach Form 8962		9	c
10	Amount paid with request for extension to file (see instructions)		10	c
11	Excess social security and tier 1 RRTA tax withheld		11	c
12	Credit for federal tax on fuels. Attach Form 4136		12	c
13	Other payments or refundable credits:			
a	Form 2439	13a		c
b	Qualified sick and family leave credits from Schedule(s) H and Form(s) 7202 for leave taken before April 1, 2021	13b		c
c	Health coverage tax credit from Form 8885	13c		c
d	Credit for repayment of amounts included in income from earlier years	13d		c
e	Reserved for future use	13e		
f	Deferred amount of net 965 tax liability (see instructions)	13f		c
g	Credit for child and dependent care expenses from Form 2441, line 10. Attach Form 2441	13g		c
h	Qualified sick and family leave credits from Schedule(s) H and Form(s) 7202 for leave taken after March 31, 2021	13h		c
z	Other payments or refundable credits. List type and amount ► _____	13z		c
14	Total other payments or refundable credits. Add lines 13a through 13z		14	c
15	Add lines 9 through 12 and 14. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 31		15	c

**SCHEDULE A
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

Itemized Deductions

▶ Go to www.irs.gov/ScheduleA for instructions and the latest information.
▶ Attach to Form 1040 or 1040-SR.

Caution: If you are claiming a net qualified disaster loss on Form 4684, see the instructions for line 16.

OMB No. 1545-0074

2021

Attachment
Sequence No. **07**

Name(s) shown on Form 1040 or 1040-SR

Your social security number

Example Taxpayer

000-00-0000

Medical and Dental Expenses	Caution: Do not include expenses reimbursed or paid by others.			
1	Medical and dental expenses (see instructions)	1	3,500	
2	Enter amount from Form 1040 or 1040-SR, line 11	2	19,507	
3	Multiply line 2 by 7.5% (0.075)	3	1,463	
4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	4		2,037
Taxes You Paid	5 State and local taxes.			
	a State and local income taxes or general sales taxes. You may include either income taxes or general sales taxes on line 5a, but not both. If you elect to include general sales taxes instead of income taxes, check this box <input type="checkbox"/>	5a	C	
	b State and local real estate taxes (see instructions)	5b	1,350	
	c State and local personal property taxes	5c	C	
	d Add lines 5a through 5c	5d	1,350	
	e Enter the smaller of line 5d or \$10,000 (\$5,000 if married filing separately)	5e	1,350	
	6 Other taxes. List type and amount ▶	6	C	
	7 Add lines 5e and 6	7		1,350
Interest You Paid	8 Home mortgage interest and points. If you didn't use all of your home mortgage loan(s) to buy, build, or improve your home, see instructions and check this box <input type="checkbox"/>			
Caution: Your mortgage interest deduction may be limited (see instructions).	a Home mortgage interest and points reported to you on Form 1098. See instructions if limited	8a	4,500	
	b Home mortgage interest not reported to you on Form 1098. See instructions if limited. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address ▶	8b	C	
	c Points not reported to you on Form 1098. See instructions for special rules	8c	C	
	d Mortgage insurance premiums (see instructions)	8d	1,500	
	e Add lines 8a through 8d	8e	6,000	
	9 Investment interest. Attach Form 4952 if required. See instructions.	9	C	
	10 Add lines 8e and 9	10		6,000
Gifts to Charity	11 Gifts by cash or check. If you made any gift of \$250 or more, see instructions	11	750	
Caution: If you made a gift and got a benefit for it, see instructions.	12 Other than by cash or check. If you made any gift of \$250 or more, see instructions. You must attach Form 8283 if over \$500.	12	C	
	13 Carryover from prior year	13	C	
	14 Add lines 11 through 13	14		750
Casualty and Theft Losses	15 Casualty and theft loss(es) from a federally declared disaster (other than net qualified disaster losses). Attach Form 4684 and enter the amount from line 18 of that form. See instructions	15		C
Other Itemized Deductions	16 Other— from list in instructions. List type and amount ▶ <u>Job expenses</u>	16		650
Total Itemized Deductions	17 Add the amounts in the far right column for lines 4 through 16. Also, enter this amount on Form 1040 or 1040-SR, line 12a	17		10,787
	18 If you elect to itemize deductions even though they are less than your standard deduction, check this box <input type="checkbox"/>			

For Paperwork Reduction Act Notice, see the Instructions for Forms 1040 and 1040-SR.

Cat. No. 17145C

Schedule A (Form 1040) 2021

**SCHEDULE C
(Form 1040)**

Profit or Loss From Business
(Sole Proprietorship)

OMB No. 1545-0074

2021

Attachment
Sequence No. **09**

Department of the Treasury
Internal Revenue Service (99)

▶ Go to www.irs.gov/ScheduleC for instructions and the latest information.

▶ Attach to Form 1040, 1040-SR, 1040-NR, or 1041; partnerships must generally file Form 1065.

Name of proprietor

Social security number (SSN)

Example Taxpayer

A Principal business or profession, including product or service (see instructions)

B Enter code from instructions

Medicinal and botanical oil manufacturing

▶ 3 2 5 4 1 1

C Business name. If no separate business name, leave blank.

D Employer ID number (EIN) (see instr.)

Example Business Name

E Business address (including suite or room no.) ▶

City, town or post office, state, and ZIP code

F Accounting method: (1) Cash (2) Accrual (3) Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2021? If "No," see instructions for limit on losses . . . Yes No

H If you started or acquired this business during 2021, check here . . .

I Did you make any payments in 2021 that would require you to file Form(s) 1099? See instructions . . . Yes No

J If "Yes," did you or will you file required Form(s) 1099? . . . Yes No

Part I Income

1 Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked . . . ▶ <input type="checkbox"/>	1	45,000
2 Returns and allowances	2	C
3 Subtract line 2 from line 1	3	45,000
4 Cost of goods sold (from line 42)	4	13,250
5 Gross profit. Subtract line 4 from line 3	5	31,750
6 Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6	C
7 Gross income. Add lines 5 and 6 ▶	7	31,750

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8 Advertising	8	250	18 Office expense (see instructions)	18	C
9 Car and truck expenses (see instructions)	9	C	19 Pension and profit-sharing plans	19	C
10 Commissions and fees	10	C	20 Rent or lease (see instructions):		
11 Contract labor (see instructions)	11	C	a Vehicles, machinery, and equipment	20a	C
12 Depletion	12	C	b Other business property	20b	C
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13	15,000	21 Repairs and maintenance	21	750
14 Employee benefit programs (other than on line 19)	14	C	22 Supplies (not included in Part III)	22	C
15 Insurance (other than health)	15	C	23 Taxes and licenses	23	C
16 Interest (see instructions):			24 Travel and meals:		
a Mortgage (paid to banks, etc.)	16a	C	a Travel	24a	C
b Other	16b	C	b Deductible meals (see instructions)	24b	250
17 Legal and professional services	17	C	25 Utilities	25	C
			26 Wages (less employment credits)	26	C
			27a Other expenses (from line 48)	27a	865
			27b Reserved for future use	27b	
28 Total expenses before expenses for business use of home. Add lines 8 through 27a ▶	28	17,115			
29 Tentative profit or (loss). Subtract line 28 from line 7	29	14,635			
30 Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method. See instructions. Simplified method filers only: Enter the total square footage of (a) your home: <u>2,100</u> and (b) the part of your home used for business: <u>300</u> . Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30	30	1,500			
31 Net profit or (loss). Subtract line 30 from line 29. • If a profit, enter on both Schedule 1 (Form 1040), line 3 , and on Schedule SE, line 2 . (If you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041, line 3 . • If a loss, you must go to line 32.	31	13,135			
32 If you have a loss, check the box that describes your investment in this activity. See instructions. • If you checked 32a, enter the loss on both Schedule 1 (Form 1040), line 3 , and on Schedule SE, line 2 . (If you checked the box on line 1, see the line 31 instructions.) Estates and trusts, enter on Form 1041, line 3 . • If you checked 32b, you must attach Form 6198 . Your loss may be limited.					

32a All investment is at risk.
32b Some investment is not at risk.

For Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11334P

Schedule C (Form 1040) 2021

Part III Cost of Goods Sold (see instructions)

33	Method(s) used to value closing inventory: a <input checked="" type="checkbox"/> Cost b <input type="checkbox"/> Lower of cost or market c <input type="checkbox"/> Other (attach explanation)	
34	Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
35	Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35 4,000
36	Purchases less cost of items withdrawn for personal use	36 15,000
37	Cost of labor. Do not include any amounts paid to yourself	37 C
38	Materials and supplies	38 25C
39	Other costs	39 C
40	Add lines 35 through 39	40 19,25C
41	Inventory at end of year	41 6,000
42	Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on line 4	42 13,25C

Part IV Information on Your Vehicle. Complete this part **only** if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 to find out if you must file Form 4562.

- 43** When did you place your vehicle in service for business purposes? (month/day/year) ▶ / /
- 44** Of the total number of miles you drove your vehicle during 2021, enter the number of miles you used your vehicle for:
- a** Business _____ **b** Commuting (see instructions) _____ **c** Other _____
- 45** Was your vehicle available for personal use during off-duty hours? Yes No
- 46** Do you (or your spouse) have another vehicle available for personal use? Yes No
- 47a** Do you have evidence to support your deduction? Yes No
- b** If "Yes," is the evidence written? Yes No

Part V Other Expenses. List below business expenses not included on lines 8–26 or line 30.

Telephone	865
48 Total other expenses. Enter here and on line 27a	48 865

SCHEDULE D
(Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040, 1040-SR, or 1040-NR.
▶ Go to www.irs.gov/ScheduleD for instructions and the latest information.
▶ Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.

OMB No. 1545-0074

2021

Attachment
Sequence No. **12**

Name(s) shown on return

Your social security number

Example Taxpayer

000-00-0000

Did you dispose of any investment(s) in a qualified opportunity fund during the tax year? Yes No

If "Yes," attach Form 8949 and see its instructions for additional requirements for reporting your gain or loss.

Part I Short-Term Capital Gains and Losses—Generally Assets Held One Year or Less (see instructions)

See instructions for how to figure the amounts to enter on the lines below.

This form may be easier to complete if you round off cents to whole dollars.

	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b				
1b Totals for all transactions reported on Form(s) 8949 with Box A checked				
2 Totals for all transactions reported on Form(s) 8949 with Box B checked				
3 Totals for all transactions reported on Form(s) 8949 with Box C checked				
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824				4 C
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5 C
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet in the instructions				6 (C)
7 Net short-term capital gain or (loss). Combine lines 1a through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back				7 C

Part II Long-Term Capital Gains and Losses—Generally Assets Held More Than One Year (see instructions)

See instructions for how to figure the amounts to enter on the lines below.

This form may be easier to complete if you round off cents to whole dollars.

	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b	2,000	1,800		200
8b Totals for all transactions reported on Form(s) 8949 with Box D checked				
9 Totals for all transactions reported on Form(s) 8949 with Box E checked				
10 Totals for all transactions reported on Form(s) 8949 with Box F checked				
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				11 C
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12 C
13 Capital gain distributions. See the instructions				13 C
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions				14 (C)
15 Net long-term capital gain or (loss). Combine lines 8a through 14 in column (h). Then, go to Part III on the back				15 200

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11338H

Schedule D (Form 1040) 2021

Part III Summary

<p>16 Combine lines 7 and 15 and enter the result</p> <ul style="list-style-type: none"> • If line 16 is a gain, enter the amount from line 16 on Form 1040, 1040-SR, or 1040-NR, line 7. Then, go to line 17 below. • If line 16 is a loss, skip lines 17 through 20 below. Then, go to line 21. Also be sure to complete line 22. • If line 16 is zero, skip lines 17 through 21 below and enter -0- on Form 1040, 1040-SR, or 1040-NR, line 7. Then, go to line 22. <p>17 Are lines 15 and 16 both gains? <input checked="" type="checkbox"/> Yes. Go to line 18. <input type="checkbox"/> No. Skip lines 18 through 21, and go to line 22.</p> <p>18 If you are required to complete the 28% Rate Gain Worksheet (see instructions), enter the amount, if any, from line 7 of that worksheet ▶</p> <p>19 If you are required to complete the Unrecaptured Section 1250 Gain Worksheet (see instructions), enter the amount, if any, from line 18 of that worksheet ▶</p> <p>20 Are lines 18 and 19 both zero or blank and are you not filing Form 4952? <input checked="" type="checkbox"/> Yes. Complete the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Forms 1040 and 1040-SR, line 16. Don't complete lines 21 and 22 below. <input type="checkbox"/> No. Complete the Schedule D Tax Worksheet in the instructions. Don't complete lines 21 and 22 below.</p> <p>21 If line 16 is a loss, enter here and on Form 1040, 1040-SR, or 1040-NR, line 7, the smaller of:</p> <ul style="list-style-type: none"> • The loss on line 16; or • (\$3,000), or if married filing separately, (\$1,500) } <p>Note: When figuring which amount is smaller, treat both amounts as positive numbers.</p> <p>22 Do you have qualified dividends on Form 1040, 1040-SR, or 1040-NR, line 3a? <input type="checkbox"/> Yes. Complete the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Forms 1040 and 1040-SR, line 16. <input type="checkbox"/> No. Complete the rest of Form 1040, 1040-SR, or 1040-NR.</p>	<p>16</p> <p>18</p> <p>19</p> <p>21</p>	<p>200</p>
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**SCHEDULE SE
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

Self-Employment Tax

► Go to www.irs.gov/ScheduleSE for instructions and the latest information.
► Attach to Form 1040, 1040-SR, or 1040-NR.

OMB No. 1545-0074

2021
Attachment
Sequence No. **17**

Name of person with self-employment income (as shown on Form 1040, 1040-SR, or 1040-NR)

Social security number of person
with self-employment income ►

000-00-0000

Example Taxpayer

Part I Self-Employment Tax

Note: If your only income subject to self-employment tax is **church employee income**, see instructions for how to report your income and the definition of church employee income.

A If you are a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361, but you had \$400 or more of **other** net earnings from self-employment, check here and continue with Part I

Skip lines 1a and 1b if you use the farm optional method in Part II. See instructions.

1a Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A **1a** C

b If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code AH **1b** (0)

Skip line 2 if you use the nonfarm optional method in Part II. See instructions.

2 Net profit or (loss) from Schedule C, line 31; and Schedule K-1 (Form 1065), box 14, code A (other than farming). See instructions for other income to report or if you are a minister or member of a religious order **2** 13,135

3 Combine lines 1a, 1b, and 2 **3** 13,135

4a If line 3 is more than zero, multiply line 3 by 92.35% (0.9235). Otherwise, enter amount from line 3 **4a** 12,130

Note: If line 4a is less than \$400 due to Conservation Reserve Program payments on line 1b, see instructions.

b If you elect one or both of the optional methods, enter the total of lines 15 and 17 here **4b**

c Combine lines 4a and 4b. If less than \$400, **stop**; you don't owe self-employment tax. **Exception:** If less than \$400 and you had **church employee income**, enter -0- and continue **4c** 12,130

5a Enter your **church employee income** from Form W-2. See instructions for definition of church employee income **5a** C

b Multiply line 5a by 92.35% (0.9235). If less than \$100, enter -0- **5b** C

6 Add lines 4c and 5b **6** 12,130

7 Maximum amount of combined wages and self-employment earnings subject to social security tax or the 6.2% portion of the 7.65% railroad retirement (tier 1) tax for 2021 **7** 142,800

8a Total social security wages and tips (total of boxes 3 and 7 on Form(s) W-2) and railroad retirement (tier 1) compensation. If \$142,800 or more, skip lines 8b through 10, and go to line 11 **8a** 12,000

b Unreported tips subject to social security tax from Form 4137, line 10 **8b** C

c Wages subject to social security tax from Form 8919, line 10 **8c** C

d Add lines 8a, 8b, and 8c **8d** 12,000

9 Subtract line 8d from line 7. If zero or less, enter -0- here and on line 10 and go to line 11 **9** 130,800

10 Multiply the **smaller** of line 6 or line 9 by 12.4% (0.124) **10** 1,504

11 Multiply line 6 by 2.9% (0.029) **11** 352

12 **Self-employment tax.** Add lines 10 and 11. Enter here and on **Schedule 2 (Form 1040), line 4** **12** 1,856

13 **Deduction for one-half of self-employment tax.** Multiply line 12 by 50% (0.50). Enter here and on **Schedule 1 (Form 1040), line 15** **13** 928

Part II Optional Methods To Figure Net Earnings (see instructions)

Farm Optional Method. You may use this method **only** if **(a)** your gross farm income¹ wasn't more than \$8,820, **or (b)** your net farm profits² were less than \$6,367.

14 Maximum income for optional methods **14** 5,880

15 Enter the **smaller** of: two-thirds ($\frac{2}{3}$) of gross farm income¹ (not less than zero) **or** \$5,880. Also, include this amount on line 4b above **15**

Nonfarm Optional Method. You may use this method **only** if **(a)** your net nonfarm profits³ were less than \$6,367 and also less than 72.189% of your gross nonfarm income,⁴ **and (b)** you had net earnings from self-employment of at least \$400 in 2 of the prior 3 years. **Caution:** You may use this method no more than five times.

16 Subtract line 15 from line 14 **16**

17 Enter the **smaller** of: two-thirds ($\frac{2}{3}$) of gross nonfarm income⁴ (not less than zero) **or** the amount on line 16. Also, include this amount on line 4b above **17**

¹ From Sch. F, line 9; and Sch. K-1 (Form 1065), box 14, code B.

³ From Sch. C, line 31; and Sch. K-1 (Form 1065), box 14, code A.

² From Sch. F, line 34; and Sch. K-1 (Form 1065), box 14, code A—minus the amount you would have entered on line 1b had you not used the optional method.

⁴ From Sch. C, line 7; and Sch. K-1 (Form 1065), box 14, code C.

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 2021

Depreciation and Amortization
(Including Information on Listed Property)

► Attach to your tax return.
► Go to www.irs.gov/Form4562 for instructions and the latest information.

Name(s) shown on return Example Taxpayer	Business or activity to which this form relates Medicinal and botanical oil manufacturing	Identifying number 000-00-0000
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Part I Election To Expense Certain Property Under Section 179

Note: If you have any listed property, complete Part V before you complete Part I.

1	Maximum amount (see instructions)	1	1,050,000
2	Total cost of section 179 property placed in service (see instructions)	2	15,000
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	1,050,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	0
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	1,050,000
6	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
	Extractor	15,000	15,000
7	Listed property. Enter the amount from line 29	7	0
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	15,000
9	Tentative deduction. Enter the smaller of line 5 or line 8	9	15,000
10	Carryover of disallowed deduction from line 13 of your 2020 Form 4562	10	0
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5. See instructions	11	40,435
12	Section 179 expense deduction. Add lines 9 and 10, but don't enter more than line 11	12	15,000
13	Carryover of disallowed deduction to 2022. Add lines 9 and 10, less line 12	13	0

Note: Don't use Part II or Part III below for listed property. Instead, use Part V.

Part II Special Depreciation Allowance and Other Depreciation (Don't include listed property. See instructions.)

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year. See instructions	14	0
15	Property subject to section 168(f)(1) election	15	0
16	Other depreciation (including ACRS)	16	0

Part III MACRS Depreciation (Don't include listed property. See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2021	17	0
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here <input type="checkbox"/>		

Section B—Assets Placed in Service During 2021 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	

Section C—Assets Placed in Service During 2021 Tax Year Using the Alternative Depreciation System

20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 30-year			30 yrs.	MM	S/L	
d 40-year			40 yrs.	MM	S/L	

Part IV Summary (See instructions.)

21	Listed property. Enter amount from line 28	21	0
22	Total. Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	22	15,000
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	0

Part V Listed Property (Include automobiles, certain other vehicles, certain aircraft, and property used for entertainment, recreation, or amusement.)

Note: For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete **only** 24a, 24b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.

Section A—Depreciation and Other Information (Caution: See the instructions for limits for passenger automobiles.)

24a Do you have evidence to support the business/investment use claimed? Yes No **24b** If "Yes," is the evidence written? Yes No

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business/investment use percentage	(d) Cost or other basis	(e) Basis for depreciation (business/investment use only)	(f) Recovery period	(g) Method/Convention	(h) Depreciation deduction	(i) Elected section 179 cost
25 Special depreciation allowance for qualified listed property placed in service during the tax year and used more than 50% in a qualified business use. See instructions 25								
26 Property used more than 50% in a qualified business use:								
		%						
		%						
		%						
27 Property used 50% or less in a qualified business use:								
		%			S/L -			
		%			S/L -			
		%			S/L -			
28 Add amounts in column (h), lines 25 through 27. Enter here and on line 21, page 1 28								
29 Add amounts in column (i), line 26. Enter here and on line 7, page 1 29								0

Section B—Information on Use of Vehicles

Complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person. If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.

	(a) Vehicle 1		(b) Vehicle 2		(c) Vehicle 3		(d) Vehicle 4		(e) Vehicle 5		(f) Vehicle 6	
	Yes	No										
30 Total business/investment miles driven during the year (don't include commuting miles)												
31 Total commuting miles driven during the year												
32 Total other personal (noncommuting) miles driven												
33 Total miles driven during the year. Add lines 30 through 32												
34 Was the vehicle available for personal use during off-duty hours?												
35 Was the vehicle used primarily by a more than 5% owner or related person?												
36 Is another vehicle available for personal use?												

Section C—Questions for Employers Who Provide Vehicles for Use by Their Employees

Answer these questions to determine if you meet an exception to completing Section B for vehicles used by employees who aren't more than 5% owners or related persons. See instructions.

	Yes	No
37 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
38 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? See the instructions for vehicles used by corporate officers, directors, or 1% or more owners		
39 Do you treat all use of vehicles by employees as personal use?		
40 Do you provide more than five vehicles to your employees, obtain information from your employees about the use of the vehicles, and retain the information received?		
41 Do you meet the requirements concerning qualified automobile demonstration use? See instructions.		

Note: If your answer to 37, 38, 39, 40, or 41 is "Yes," don't complete Section B for the covered vehicles.

Part VI Amortization

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
42 Amortization of costs that begins during your 2021 tax year (see instructions):					
43 Amortization of costs that began before your 2021 tax year 43					0
44 Total. Add amounts in column (f). See the instructions for where to report 44					0

Education Credits
(American Opportunity and Lifetime Learning Credits)

▶ Attach to Form 1040 or 1040-SR.
▶ Go to www.irs.gov/Form8863 for instructions and the latest information.

Name(s) shown on return

Your social security number
000 00 0000

Example Taxpayer



Complete a separate Part III on page 2 for each student for whom you're claiming either credit before you complete Parts I and II.

Part I Refundable American Opportunity Credit

1	After completing Part III for each student, enter the total of all amounts from all Parts III, line 30	1	2,500
2	Enter: \$180,000 if married filing jointly; \$90,000 if single, head of household, or qualifying widow(er)	2	180,000
3	Enter the amount from Form 1040 or 1040-SR, line 11. If you're filing Form 2555 or 4563, or you're excluding income from Puerto Rico, see Pub. 970 for the amount to enter	3	33,447
4	Subtract line 3 from line 2. If zero or less, stop ; you can't take any education credit	4	146,553
5	Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er)	5	10,000
6	If line 4 is: • Equal to or more than line 5, enter 1.000 on line 6 • Less than line 5, divide line 4 by line 5. Enter the result as a decimal (rounded to at least three places)	6	1 .000
7	Multiply line 1 by line 6. Caution: If you were under age 24 at the end of the year and meet the conditions described in the instructions, you can't take the refundable American opportunity credit; skip line 8, enter the amount from line 7 on line 9, and check this box ▶ <input type="checkbox"/>	7	2,500
8	Refundable American opportunity credit. Multiply line 7 by 40% (0.40). Enter the amount here and on Form 1040 or 1040-SR, line 29. Then go to line 9 below.	8	1,000

Part II Nonrefundable Education Credits

9	Subtract line 8 from line 7. Enter here and on line 2 of the Credit Limit Worksheet (see instructions)	9	1,500
10	After completing Part III for each student, enter the total of all amounts from all Parts III, line 31. If zero, skip lines 11 through 17, enter -0- on line 18, and go to line 19	10	0
11	Enter the smaller of line 10 or \$10,000	11	0
12	Multiply line 11 by 20% (0.20)	12	0
13	Enter: \$180,000 if married filing jointly; \$90,000 if single, head of household, or qualifying widow(er)	13	180,000
14	Enter the amount from Form 1040 or 1040-SR, line 11. If you're filing Form 2555 or 4563, or you're excluding income from Puerto Rico, see Pub. 970 for the amount to enter	14	33,447
15	Subtract line 14 from line 13. If zero or less, skip lines 16 and 17, enter -0- on line 18, and go to line 19	15	146,553
16	Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er)	16	10,000
17	If line 15 is: • Equal to or more than line 16, enter 1.000 on line 17 and go to line 18 • Less than line 16, divide line 15 by line 16. Enter the result as a decimal (rounded to at least three places)	17	1 .000
18	Multiply line 12 by line 17. Enter here and on line 1 of the Credit Limit Worksheet (see instructions) ▶	18	0
19	Nonrefundable education credits. Enter the amount from line 7 of the Credit Limit Worksheet (see instructions) here and on Schedule 3 (Form 1040), line 3	19	0

Name(s) shown on return

Your social security number

Example Taxpayer

000 00 0000



Complete Part III for each student for whom you're claiming either the American opportunity credit or lifetime learning credit. Use additional copies of page 2 as needed for each student.

Part III Student and Educational Institution Information. See instructions.

<p>20 Student name (as shown on page 1 of your tax return)</p> <p>Example Taxpayer</p>	<p>21 Student social security number (as shown on page 1 of your tax return)</p> <p>000 00 0000</p>
<p>22 Educational institution information (see instructions)</p>	
<p>a. Name of first educational institution</p> <p>Smalltown Community College</p> <p>(1) Address. Number and street (or P.O. box). City, town or post office, state, and ZIP code. If a foreign address, see instructions.</p> <p>PO Box 1234 Anytown, FL 00000</p> <p>(2) Did the student receive Form 1098-T from this institution for 2021? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No</p> <p>(3) Did the student receive Form 1098-T from this institution for 2020 with box 7 checked? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No</p> <p>(4) Enter the institution's employer identification number (EIN) if you're claiming the American opportunity credit or if you checked "Yes" in (2) or (3). You can get the EIN from Form 1098-T or from the institution.</p> <p>0 0 - 0 0 0 0 0 0 0 0</p>	<p>b. Name of second educational institution (if any)</p> <p>(1) Address. Number and street (or P.O. box). City, town or post office, state, and ZIP code. If a foreign address, see instructions.</p> <p>(2) Did the student receive Form 1098-T from this institution for 2021? <input type="checkbox"/> Yes <input type="checkbox"/> No</p> <p>(3) Did the student receive Form 1098-T from this institution for 2020 with box 7 checked? <input type="checkbox"/> Yes <input type="checkbox"/> No</p> <p>(4) Enter the institution's employer identification number (EIN) if you're claiming the American opportunity credit or if you checked "Yes" in (2) or (3). You can get the EIN from Form 1098-T or from the institution.</p> <p>- - - - -</p>
<p>23 Has the Hope Scholarship Credit or American opportunity credit been claimed for this student for any 4 tax years before 2021? <input type="checkbox"/> Yes — Stop! Go to line 31 for this student. <input checked="" type="checkbox"/> No — Go to line 24.</p>	
<p>24 Was the student enrolled at least half-time for at least one academic period that began or is treated as having begun in 2021 at an eligible educational institution in a program leading towards a postsecondary degree, certificate, or other recognized postsecondary educational credential? See instructions. <input checked="" type="checkbox"/> Yes — Go to line 25. <input type="checkbox"/> No — Stop! Go to line 31 for this student.</p>	
<p>25 Did the student complete the first 4 years of postsecondary education before 2021? See instructions. <input type="checkbox"/> Yes — Stop! Go to line 31 for this student. <input checked="" type="checkbox"/> No — Go to line 26.</p>	
<p>26 Was the student convicted, before the end of 2021, of a felony for possession or distribution of a controlled substance? <input type="checkbox"/> Yes — Stop! Go to line 31 for this student. <input checked="" type="checkbox"/> No — Complete lines 27 through 30 for this student.</p>	



You can't take the American opportunity credit and the lifetime learning credit for the same student in the same year. If you complete lines 27 through 30 for this student, don't complete line 31.

American Opportunity Credit	
27 Adjusted qualified education expenses (see instructions). Don't enter more than \$4,000	27 4,000
28 Subtract \$2,000 from line 27. If zero or less, enter -0-	28 2,000
29 Multiply line 28 by 25% (0.25)	29 500
30 If line 28 is zero, enter the amount from line 27. Otherwise, add \$2,000 to the amount on line 29 and enter the result. Skip line 31. Include the total of all amounts from all Parts III, line 30, on Part I, line 1	30 2,500
Lifetime Learning Credit	
31 Adjusted qualified education expenses (see instructions). Include the total of all amounts from all Parts III, line 31, on Part II, line 10	31 0

APPENDIX B

Criminal Violations

Internal Revenue Manual (IRM) 25.1 Fraud Handbook, Exhibit 25.1.1-1

Criminal Statutes	Elements Necessary for Prosecution
<p>Title 26 USC Section 7201 (Evasion) Felony</p>	<ul style="list-style-type: none"> • Willfulness • Attempt to evade or defeat (usually involves concealment or deception) tax or payment thereof • Tax deficiency
<p>Title 26 USC Section 7202 (Trust Fund Violation—Willful Failure to Collect or Pay Over Tax) Felony</p>	<ul style="list-style-type: none"> • Willfulness • Requirement to collect, truthfully account for, and pay over employment taxes • Either failure to collect any tax or failure to truthfully account for and pay over any tax or both
<p>Title 26 USC Section 7203 (Failure to File or Failure to Pay) Misdemeanor</p>	<ul style="list-style-type: none"> • Willfulness • Requirement to file a return, pay an estimated tax or tax, maintain records, or supply information • Failure to file a return, pay an estimated tax or tax, maintain records, or supply information
<p>Title 26 USC Section 6050I in Conjunction with 26 USC Sections 7203 and 7206 (Trade or Business Required to File a Form 8300 for Receiving More Than \$10,000 Cash) Felony</p>	<ul style="list-style-type: none"> • Willfulness • Subject to reporting requirement relating to cash of more than \$10,000 received in trade or business • Evasion of reporting requirement by: <ul style="list-style-type: none"> a. Causing a trade or business to fail to file report, or b. Causing a trade or business to file false report, or c. Structuring transactions to avoid report
<p>Title 26 USC Section 7204 (Employee Wage Statements) Misdemeanor</p>	<ul style="list-style-type: none"> • Duty to deduct and withhold employment tax or income tax (26 USC 3102(a), 3402(a)) • Duty to timely furnish to the employee a written statement showing specified information concerning the deductions (26 USC 6051) • Furnishing a false or fraudulent statement to an employee, or the failure to furnish a statement to an employee at the required time and in the required manner • Willfulness
<p>Title 26 USC Section 7205 (False W-4) Misdemeanor</p>	<ul style="list-style-type: none"> • Duty to supply information to employer regarding income tax withholding (26 USC 3402(f)(2)) • Furnishing false or fraudulent information or failure to supply information, which would require an increase in tax to be withheld • Willfulness

Criminal Statutes	Elements Necessary for Prosecution
Title 26 USC Section 7206(1) (False return) Felony	<ul style="list-style-type: none"> • Making and subscribing a return or other document under penalties of perjury • The return, statement or other document, which was false as to a material matter • Belief that it is not true and correct as to every material matter • Willfulness
Title 26 USC Section 7206(2) (Assisting in Preparation of False Return) Felony	<ul style="list-style-type: none"> • Aiding or assisting in, procuring, counseling, or advising the preparation or presentation of a document in connection with matters arising under the internal revenue laws • Document was false as to a material matter • Willfulness
Title 26 USC Section 7206(4) (Removal or Concealment with Intent to Defraud) Felony	<ul style="list-style-type: none"> • Tax imposed on property • Property on which tax is imposed or will be imposed or levy is authorized • Removal or concealment • Intent to evade or defeat assessment or collection of tax
Title 26 USC Section 7206(5) (Compromises & Closing Agreements) Felony	<ul style="list-style-type: none"> • Willful concealment of property or • Willful withholding, falsifying and destroying records • Receives, withholds, destroys, mutilates, or falsifies any book, document, or record, or makes any false statement.
Title 26 USC Section 7207 (Submission of False Documents) Misdemeanor	<ul style="list-style-type: none"> • Willfulness • Delivery or disclosure to any officer or employee of the Internal Revenue Service of any list, return, account, statement, or other document Return, statement, or other document is false or fraudulent as to a material matter • Knowledge of material falsity
Title 26 USC Section 7212(a) "Omnibus Clause" Felony	<ul style="list-style-type: none"> • Corrupt effort, endeavor, or attempt • To impede, obstruct or interfere with • Due administration of Title 26
Title 26 USC Section 7212(a) (Corrupt or Forcible Interference) Felony or Misdemeanor	<ul style="list-style-type: none"> • Use of force or threat • To intimidate, impede or obstruct • An officer or employee of the U.S. acting in official capacity under Title 26
Title 26 USC Section 7212(b) (Forcible Rescue of Seized Property) Felony	<ul style="list-style-type: none"> • Forcible rescue or attempt to forcibly rescue • Seized property • Knowledge of seizure

Criminal Statutes	Elements Necessary for Prosecution
Title 26 USC Section 7215 (Collection & Paying Tax) Misdemeanor	<ul style="list-style-type: none"> • Taxpayer was a person required to collect, account for, and pay over income tax withholding on wages and FICA taxes • Taxpayer was notified of the failure to collect, account for, and pay over • Taxpayer failed to collect, account for, and pay over the taxes, while not entertaining a reasonable doubt as to whether the law required the taxpayer to do so, and the failure was not due to circumstances beyond the taxpayer's control
Title 26 USC Section 7232 (Failure to Register) Felony	<ul style="list-style-type: none"> • Fails to register in connection with taxable purchase - diesel fuel and special motor fuels, or • Falsely represents that he is registered, or • Willfully makes false statement in an application for registration.
Title 18 USC Section 2 (Principal/Aiding and Abetting) Felony or Misdemeanor	<ol style="list-style-type: none"> a. Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal b. Whoever willfully causes an act to be done which if directly performed by him or another would be an offense against the United States, is punishable as a principal.
Title 18 USC Section 152(1) (Concealment of Property) Felony	<ul style="list-style-type: none"> • Bankruptcy proceeding was in existence; • Individual fraudulently concealed the property from the custodian; and • Property belonged to the bankruptcy estate.
Title 18 USC Section 152(2) (False Oath or Account) Felony	<ul style="list-style-type: none"> • Existence of a bankruptcy proceeding; • Statement under oath; • Statement must be false; and • Statement was made knowingly and fraudulently makes a false oath or account in or in relation to any case under title 11.
Title 18 USC Section 152(3) (False Declarations) Felony	<ul style="list-style-type: none"> • Existence of a bankruptcy proceeding; • Individual made a false declaration, certificate, verification, or other statement in relation to the bankruptcy proceeding; • Statement was knowingly and fraudulently makes a false declaration, certificate, verification, or statement under penalty of perjury as permitted under Section 1746 of Title 28, in or in relation to any case under title 11.

Criminal Statutes	Elements Necessary for Prosecution
Title 18 USC Section 152(4) (False Claims) Felony	<ul style="list-style-type: none"> • Bankruptcy proceedings have commenced; Individual presented or caused to be presented a proof of claim in the bankruptcy; • Proof of claim was false as to a material matter; and • Individual knew the proof of claim was false and acted knowingly and fraudulently presents any false claim for proof against the estate of a debtor, or uses any such claim in any case under title 11, in a personal capacity or as or through an agent, proxy, or attorney;
Title 18 USC Section 152(5) (Fraudulent Receipt of Property) Felony	<ul style="list-style-type: none"> • Individual receives a material amount of property from a debtor • Such transfer occurred after the filing of a case under Title 11; and • Acts were done with the intent to defeat the provisions of Title 11.
Title 18 USC Section 152(6) (Extortion and Bribery) Felony	<ul style="list-style-type: none"> • Individual gives, offers, receives, or attempts to obtain money or property, remuneration, compensation, reward, advantage, or promise for acting or forbearing to act in any case under Title 11; and • Action was made knowingly and fraudulently.
Title 18 USC Section 152(7) (Fraudulent Transfer or Concealment) Felony	<ul style="list-style-type: none"> • Individual fraudulently transferred or concealed the defendant's property or the property of another; an • Such act of transfer or concealment was done with the intent to defeat the provisions of Title 11, or in contemplation of a case under Title 11.
Title 18 USC Section 152(8) (Destruction or Alteration of Recorded Information) Felony	<ul style="list-style-type: none"> • Bankruptcy proceeding existed • Individual concealed, destroyed, or mutilated the documents; • Such documents related to the property or financial affairs of the debtor; and • Individual acted knowingly and fraudulently.
Title 18 USC Section 152(9) (Withholding of Recorded Information) Felony	<ul style="list-style-type: none"> • Bankruptcy proceeding existed; • Individual withheld from the trustee entitled to its possession; books, documents, records, or papers; • Such documents related to the property or financial affairs of the debtor; an • Individual withheld the documents knowingly and fraudulently.

Criminal Statutes	Elements Necessary for Prosecution
Title 18 USC Section 157 (Bankruptcy Fraud) Felony	<ul style="list-style-type: none"> • Defendant devised or intended to devise a scheme or artifice to defraud; and • For the purpose of executing or concealing such scheme or artifice or attempting to do so; • Files a petition under Title 11; or • Files a document in a proceeding under Title 11; or • Makes a false or fraudulent representation, claim, or promise concerning or in relation to a proceeding under Title 11
Title 18 USC Section 286 (Conspiracy to Defraud the government with Respect to Claims) Felony	<ul style="list-style-type: none"> • An agreement, combination, or conspiracy to defraud the United States • By obtaining or aiding to obtain the payment of any false, fictitious or fraudulent claim.
Title 18 USC Section 287 (False Fictitious or Fraudulent Claims) Felony	<ul style="list-style-type: none"> • Knowingly makes or presents (statute does not require that person providing false information to return discounter* who filed return actually file return to be guilty under 287) • False, fictitious or fraudulent claim • Knowing that claim filed is false, fictitious or fraudulent. <p>Note: * Files return for a percentage of the refund.</p>
Title 18 USC Section 371 (Conspiracy) Felony	<ul style="list-style-type: none"> • The general conspiracy statute encompasses two distinct types of conspiracies; <ul style="list-style-type: none"> a. Conspiracy to commit any federal offense b. Conspiracy to defraud the United States or <i>any</i> agency thereof, which includes the Service • Essential elements of a Section 371 offense are: <ul style="list-style-type: none"> a. <i>Agreement</i> by two or more parties b. To <i>commit an offense</i> against the United States; or, to <i>defraud</i> the United States or one of its agencies c. <i>Overt act</i> by one or more of the parties in furtherance of the agreement d. <i>Requisite intent</i> to defraud or to commit the substantive offense

Criminal Statutes	Elements Necessary for Prosecution
<p>Title 18 USC Section 1001 (False Statements) Felony</p>	<ul style="list-style-type: none"> • Either: <ul style="list-style-type: none"> a. Falsifying, concealing or covering up any material fact by any trick, scheme, or device; or b. Making false, fictitious or fraudulent statements or representations; or c. Making or using any false writing or document. • Knowingly and willfully • In a matter within the jurisdiction of a department or agency of the United States • False matter was of a material nature.
<p>Title 18 USC 1956 (Laundering of Monetary Instruments) Felony</p>	<ul style="list-style-type: none"> • Whoever, knowing that property involved in a financial transaction represents proceeds of a specified unlawful activity (SUA). • Conducts such a financial transaction, which in fact involves proceeds of a SUA: <ul style="list-style-type: none"> A. <ul style="list-style-type: none"> i. with the intent to promote the carrying on of SUA; or ii. with the intent to engage in conduct constituting a violation of section 7201 or 7206 of the IRC; or B. knowing the transaction is designed in whole or in part: <ul style="list-style-type: none"> i. to conceal or disguise the nature, location, source, ownership, or control of the proceeds of SUA; or ii. to avoid a transaction reporting requirement under State or Federal law.