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sends the first notice to the taxpayer. However, this is not the case.

**Dave DuVal** • Dec. 05, 2019



It is not uncommon for taxpayers, and even some tax professionals, to assume that the examination process begins when the Tax Compliance Officer or Revenue Agent sends the first notice to the taxpayer. However, this is not the case. Before a taxpayer is notified by the IRS that their income tax return is being audited, the IRS examiner assigned to the audit conducts a series of preliminary or pre-audit tasks in order to identify potential audit issues and the possibility of unreported income and fraud.

It is the goal of the examiner to analyze the entire return before even speaking to the taxpayer. One of the pre-contact responsibilities of the assigned examiner is to conduct a preliminary financial status analysis. A financial status analysis is

considered to be a “minimum income probe” not subject to IRC §7602(e) because it is

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examiners, especially Tax Compliance Officers, only have a limited time to conduct the initial pre-contact analysis.

Both business and personal finances are taken into consideration when the examiner conducts an analysis of the information on the taxpayer's return. If an income tax return contains the amounts of actual personal living expenses (referred to as “PLE” by the IRS) such as mortgage interest, property taxes paid, medical expenses paid, and charitable contributions, the IRS will use those figures when conducting the preliminary financial status analysis.

***If the actual living expense amounts are provided by the taxpayer, the IRS examiner may not use statistical information available to the general public, even if the use of the statistical information results in higher taxable income.***

In the absence of actual expenses, personal living expenses are estimated using information from the [Bureau of Labor Statistics](#) (BLS), National Standards for Allowable Living Expenses (ALE) (available through the IRS website), [Bureau of the Census](#), and other comparable statistics from sources the IRS has deemed reliable. At this stage, the IRS may use only the information that is available to the general public.

Regarding pre-contact financial analysis, Treasury Regulation 301.7602-2(d)(1) states that no officer or employee of the IRS may contact a third party other than the taxpayer when it comes to the determination or collection of a taxpayer's tax liability without providing reasonable advance notice to the taxpayer. Government entities such as the BLS, U.S. Post Office, and the county clerk's office are not considered third parties, and, therefore the IRS does not need to notify the taxpayer ahead of time when reviewing these public records. Depending on the state, information from the Department of Motor Vehicles can be considered a third-party contact. This is due to anti-stalking law legislation.

The IRS will use information from their own Audit Technique Guides (ATG) and

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to assist the examiner in analyzing the data that was reported on the taxpayer's income tax return. The examiner will use the information presented on the return to complete the Cash-T analysis. The results help the IRS examiner determine whether there is a potential understatement of income. If there are considerably more expenses than income, the auditor will ask the taxpayer follow-up questions regarding the imbalance. If the taxpayer provides credible verbal explanations and supporting documentation, the examiner will note this in the case file. However, if the imbalance between income and expenses is not adequately explained, the examiner will continue to assess the imbalance using other financial status analysis tools.

Sources of cash funds are entered on the left side (debits) of the Cash-T analysis, and expenditures of cash funds go on the right side (credits). Total income sources are compared with total expenditures to determine if there is an understatement of income. This direct method got its name because of the way it is structured.

Merely having an excess of income over deductions does not get a taxpayer "out of the woods" with an audit. The examiner will take into consideration where a taxpayer lived during the tax year, how many dependents they had, and if they owned a home. For example, suppose in 2018 a single taxpayer who had no dependents, worked fulltime, went to graduate school, owned their own home, and a small home they inherited from their parents that was converted into a rental. After taking into consideration all of their wages, gross rental income, withholding from wages, rental expenses (not including depreciation), and itemized deductions, the taxpayer had net income for the year of \$15,500.

On the surface it seems as if the taxpayer may not have had any unreported income or overstated deductions. The IRS examiner may not ask any further questions such as if the taxpayer had any cash on hand or nontaxable, unreportable income,

especially if the taxpayer lived in Omaha or Buffalo. However, if the taxpayer lived in

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before communicating with the IRS a tax practitioner will be in a better position to successfully represent their client.

[\[1\]](#) IRM 4.10.4.3.3.1

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