Indirect Audit Procedures Chapter Index

Purpose

This chapter is meant to introduce the auditor to indirect methods that may be used in audits where limited records are available.

Disclaimer

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10.1 Introduction

10.2 Basic Principles Of An Indirect Audit Approach

10.3 1099-K Method

10.4 Bank Deposits Method

- 10.4.1 Recognizing Unusual Bank Deposits
- 10.4.2 Other Issues Concerning Bank Deposits
- 10.4.3 Checking Accounts / Disbursement Register

10.5 Percentage Mark-Up Method

- 10.5.1 Percentage Mark-Up Procedure
- 10.5.2 Cost Of Goods/Inventory Purchases
- 10.5.3 Margin And Mark-Up

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10.5.4 Limitations

10.6 Unit And Volume Method

10.7 Risk Management Association (RMA) Mark-Up

10.8 Deductions And Low-Rate Sales

10.8.1 High Rate Vs. Low Rate

10.8.2 Other Resources

10.9 Investigative Tools

10.10 Referrals To The ILCC and Tax on Liquor

10.10.1 Assessing Tax on Liquor & Referrals to ILCC

10.10.2 Indications that a Referral to ILCC is Necessary

10.10.3 How to Refer a Retailer to the Illinois Liquor Control Commission

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10.1 Introduction

This chapter will deal with some indirect methods that may be used in audits where limited records are available, or records are found to be unreliable. Auditors should review Chapter 6 of the audit manual for the audit process and the protest processes.

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Indirect audit procedures developed by the Department are relatively simple and straightforward. However, compiling and documenting information can be detailed and time consuming. The results must be relied upon to be reasonable, fairly accurate, and represent the activity of the taxpayer under audit. It is also necessary that the audit results can be duplicated.

The audit examination period will be subject to change and is based on several factors such as the type of records a taxpayer provides, the quantity of transactions a taxpayer has, and the potential lack of records in an audit. Sometimes a smaller examination period is deemed the most effective and other times a detailed examination may be necessary.

Several indirect methods are available to determine the correct tax liability of taxpayers with inadequate or incomplete records. These methods may also be used where the records suggest underreporting may exist. Several examples could include but are not limited to a taxpayer's records not including any detail on individual transactions, a taxpayer only providing a few months of records for an audit that spans several years, or a taxpayer failing to provide any records.

Common indirect methods are:

- 1099-K Method
- Bank Deposit Method
- Percentage Mark-up Method
- Unit and Volume Method
- Risk Management Association (RMA) Markup

Each of these methods is discussed in greater detail in the subsequent sections of this chapter.

The facts and circumstances of each case will dictate choosing the appropriate indirect method to be used. Only one method is required in any case. However, auditors may decide to use other methods if needed.

If more than one method is used, with vastly different results, the reliability of each method needs to be analyzed and discussed in the comments defending the method chosen. Attempt to identify the factors which skew the results of any methods that have been used. This will prepare the auditor if the audit is unagreed resulting in a Fast Track Resolution Conference, an Informal Conference Board Conference, or a formal protest.

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This is typically the first method auditors should use to determine a tax liability in an audit with limited records. If the taxpayer accepts cash and credit cards this method will provide a total for all sales based on their credit card sales as discussed below. If the taxpayer only accepts cash payments this method cannot be used.

Effective 12/13/2019, Form 1099-K is required to be filed in Illinois by payment processors. The form includes the gross amount of all reportable payment transactions made in settlement of payment card transactions (e.g., credit and debit cards) and third-party payment networks (e.g., PayPal) when payments are as follows (source ILGA.gov):

- Starting with the 2019 tax year, Forms 1099-K must be filed with Illinois if the taxpayer is required by the Internal Revenue Service (IRS) to electronically file Forms 1099-K.
- Starting with the 2020 tax year and after, Forms 1099-K must be submitted electronically to Illinois when four or more separate transactions exceed $1,000 or if the taxpayer is required by the IRS to electronically file Forms 1099-K.

It is not uncommon for taxpayers to receive multiple 1099-Ks for one calendar year. For example, a restaurant could have one 1099-K for their credit card machine located at the Point-of-Sale system and another 1099-K for the online food delivery service (e.g., Grubhub).

When records are limited or non-existent, the 1099-K information will provide the auditor with the amount of credit card sales. Since most businesses accept cash as a form of payment, the auditor must determine how much of the taxpayer's total sales are cash versus credit.

If the taxpayer has enough records to determine a representative cash to credit ratio, the taxpayer's records should be used to calculate the cash to credit ratio. If the analysis of the taxpayer's records or the interview with the taxpayer indicates there is cash that is being accepted, and potentially not reported, or included in the taxpayer's records then, the Department calculated default percentages should be used.

The Department default percentage ratios were calculated as follows:

> The cash and credit card percentages were calculated by Audit Planning using Data Analytics Discovery. All ST-1 filers were part of the original total population. All out-of-state businesses (with no physical IL locations) were excluded from the population. Furthermore, all businesses that do not have credit card sales (1099K information) were also removed from the population. The businesses were sorted by NAICS code prior to analyzing the data. Outliers were removed by excluding remaining businesses that had a 1099K ratio less than zero or greater than one: 1099K ratio = (1099K receipts) / (ST-1 Line 1 receipts). The total annual sales as reported on the ST-1 returns as filed were compared to the corresponding 1099K amounts for each NAICS code. The total annual 1099K receipts were divided by the total sales as reported on Line 1 of the ST-1 returns (annual totals) to arrive at the percentage of credit card sales to total sales reported to IDOR. Ratios were calculated using average percentages.

Deductions from the 1099-K should only be allowed if the taxpayer can provide documentation

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that the 1099-K Gross Amount included allowable deductions. Auditors will determine the composition of the taxpayer's 1099-K to verify that the Gross Amount on the 1099-K does not include sales in other states. This can be accomplished by verifying that the business exclusively operates in Illinois and does not have affiliations outside of Illinois.

The following are some examples of non-taxable transactions that might be included in the 1099-K Gross Amount by the payment processor:

- Sales Tax – Sales taxes collected by the taxpayer from their customers who use an electronic payment method will typically be included.
- Tips – Tips added to a credit card for a restaurant or bar should be included.
- Cash Back – If customers are allowed to receive cash back when they use their payment cards, the cash back amount will be included.
- Refunds – If the taxpayer processed electronic payment refunds after the original transaction had been settled during the calendar year, these will NOT be included.

The auditor will verify what amounts should be removed to the best of their ability; however, if it is unclear what is included in the 1099-K Gross Amount, then it will be up to the taxpayer to provide documentation that supports the amounts to deduct. The taxpayer must provide documented evidence of all nontaxable transactions included in the POS reports.

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The bank deposit method attempts to determine receipts from a taxpayer's business which have been deposited into checking and/or savings accounts. When a bank account is maintained for the business, a bank deposit analysis should be attempted. The purpose of the bank deposit analysis is to determine the sources of all funds. The business receipts may have been deposited into a business or personal account, used to purchase a certificate of deposit, or used to repay a loan. The taxpayers may have bank accounts, CDs, and loans with several financial institutions. Auditors may be able to schedule this information directly from the taxpayer's' copies of deposit slips and/or bank statements. Auditors have the right to request the records from the Financial Institutions by Subpoena Deuces Tecum if needed. One of the biggest problems that may be encountered in this type of exam is identifying all the taxpayer's bank accounts.

Auditors always have the option to contact the IRS to determine if information for all bank accounts has been made available. In situations where a taxpayer's records appear suspect, the request for return information, Form 8796-A, should be prepared and forwarded to the audit supervisor immediately. Once the auditor submits the properly completed form and receives a response with the data requested, the auditor will be able to verify federal tax returns filed and the tax years filed. The auditor may also request bank account information in Section B, "Other" of the Form 8796-A. This form is a work item in GenTax. The work item should be added within the Audit springboard to ensure its association to the applicable audit.

Note: When an actual copy of returns is being requested from the IRS, the actual 8796-A needs to be completed. Creation of the work item isn't sufficient for a request.

In addition to the receipts deposited into the taxpayer's bank accounts, the auditor will add to the analysis any known cash payouts, which have been used to purchase merchandise or services with cash prior to making the bank deposit. Cash payouts may be found on daily cash register checkout sheets or from invoices/delivery tickets which were paid with cash. "Cash" may include checks (e.g., government checks or paychecks cashed) received from customers and given to vendors as payment. The total of bank deposits and cash payouts is then compared to the gross receipts reported on the returns as filed. The difference represents potential unreported taxable receipts. During the opening interview and in subsequent conversations auditors should question the taxpayer on how they account for cash payouts in their records.

10.4.1 Recognizing Unusual Bank Deposits

In using the bank deposits method for developing gross receipts, consider whether there are any unusual deposits which did not result from business receipts. It will be up to the taxpayer to provide evidence that any unusual deposits are not taxable business receipts.

Unusual deposits are recognizable by:

- Size of Deposit - Due to expediency, the examination may be limited to large deposits only. However, the identification of smaller deposits may be indicative of dividend, interest, or other income, leading to a source not associated with business receipts.

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- Kind of Deposit - An item of deposit may be unusual due to the kind of deposit, check or cash, in its relationship to the taxpayer's business or source of income. For example, the taxpayer may be depositing large sums of cash received for money orders, traveler’s checks, or for a money wire transfer service. There may also be unusual withdrawals, usually large amounts, for cashing payroll checks, etc. When these types of transactions are occurring in a taxpayer’s bank account(s), it is very important to gain control over the adjustments being made to the account. An explanation may be required if a large cash deposit is made by a taxpayer whose receipts normally consist primarily of checks. Also, one or two large even dollar deposits, in lieu of the normal odd dollar and cents deposits, would be unusual and would require explanation. Besides verbal explanations, make sure the taxpayer can present written documentation which can be traced by the auditor.

- Frequency of Deposits - Many taxpayers, due to the nature of their business or convenience of the depository, will follow a set pattern in making deposits. Deviation from this pattern may bear questioning. Also, repeat deposits of the same amount on a monthly, quarterly, or semi-annual basis may indicate rental, dividend, interest or other non-business-related income accruing to the taxpayer.

10.4.2 Other Issues Concerning Bank Deposits

- Are there any loans, repayment of loans, or extraneous items reflected in deposits? In the analysis of the bank deposits, determine all items of this nature. This is a necessary step before comparing receipts with deposits. A bank loan will normally mean that some type of profit and loss statement will be on file at the lender bank.

- Are there transfers between bank accounts or re-deposits? Before any conclusion on the relationship between deposits and reported receipts can be reached, transfers and re-deposits must be eliminated as well as Non-Sufficient Funds (NSF) and returned checks. In order to allow for transfers between accounts all the bank statements for the account in question must have been presented by the taxpayer. If a taxpayer draws a business check, which will be converted to cash for the purpose of cashing payroll checks and then re-deposits the checks cashed, it would be incorrect to compare total deposits to receipts reported without eliminating these transactions. For example, some deposits may be re-deposits for the sole reason that a customer's check may not have cleared the bank the first time through the customer's own bank account. Therefore, use care not to overstate the taxpayer's receipts in such circumstances. The practice of "kiting" may sometimes be encountered and could mislead the auditor into faulty conclusions. ("Kiting" is the practice of writing bad checks to get money or credit.)

- Are there personal or non-business bank accounts? Do not overlook these accounts in the analysis. Ascertain whether the deposits as reflected in these accounts are from other known sources of funds. In many instances, unreported business receipts find their way into the business owner’s personal accounts. If the examination is limited to an analysis of only the business bank accounts, these unreported amounts may not be discovered.

- Reviewing the bank deposits for a short period of time, for example, three months or a quarter, and comparing that to the receipts reported may show differences whereas examining deposits

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for a full year may show everything being correct. It is not uncommon to find total deposits on a yearly basis tying in with the total receipts for the year. However, a closer examination on a weekly or monthly basis may indicate that these deposits are out of proportion with receipts reported during shorter periods of time.

10.4.3 Checking Accounts / Disbursement Register

The main purpose of the taxpayer's check disbursements analysis is to verify inventory purchases or business operating expenses. This is also where an auditor can identify from whom the taxpayer is purchasing inventory. Reviewing checks may also give indications of the reliability or unreliability of other records under examination. When using the bank deposit method, determine who has authority to sign the checks. Also, when using this method, spot check the invoices that state “Paid by Check #XXX.” Make sure the check number is a part of the check number sequence that was provided during the audit. By examining the cancelled checks, the auditor can also obtain vendor names for circularization purposes.

The extent of the check analysis will depend on each individual case and the possibility of its development through one of the other indirect methods described later. On certain occasions, all that may be required is a quick examination of the checks or check stubs to see if the non-business expenditures, such as checks for personal and investment purposes, are justified by the size of the income reported. On other occasions, a more detailed analysis may be required due to the inadequacy of other records or the possibility of omitted income.

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Generally, this method will only be used in cases where there are no 1099-K statements available; i.e., when the taxpayer only accepts cash.

The percentage mark-up method is used to determine the taxpayer's average mark-up for either the entire business or specific categories of sales. This mark-up is applied to the taxpayer's cost of goods sold to arrive at expected sales. The percentage mark-up method is effective when applied to businesses, such as taverns and liquor stores, whose purchases can be readily broken down in groups with approximately the same percentage of mark-up.

Expected Sales = Cost of Goods Sold x Mark-up Factor

Cost of Goods Sold (COGS) = Beginning Inventory + Purchases – Ending Inventory

10.5.1 Percentage Mark-Up Procedure

With this method, mark-ups are calculated from the taxpayer's purchases and selling prices. The mark-up should be representative of the business being audited. Mark-up percentages may be determined from other periods on the taxpayer's account or from an analysis of subsidiary records. Percentages may be secured from the examination of the taxpayer's records even though the records may be incomplete. Gross profit percentages may be determined by comparing purchase invoices to sales invoices, and by analyzing price lists and other similar data. Also, years not covered by the examination or portions of years under examination may indicate typical percentages applicable to the audit period. The audit narrative must thoroughly explain how the mark-up was calculated and the information used to calculate the mark-up.

10.5.2 Cost Of Goods/Inventory Purchases

When the costs of goods sold/inventory purchases are available, the purchases should be scheduled out and examined. Similar purchases such as fuel, food, liquor, or tobacco should be grouped together. The appropriate percentage of mark-up should then be applied to each group of items to arrive at the gross receipts.

Retailers are required to conduct and record at least an annual inventory of their stock on hand (86 Ill. Adm. Code 130.805(a)). Although an inventory conducted by a third party is best, that is not required. Like other taxpayer records, the auditor must assume the records are accurate unless the auditor has evidence they are not.

In many cases, the taxpayer will have no record of an actual physical inventory. The taxpayer may ask the auditor to use the amounts they record on their federal income tax return, instead. In the absence of reliable inventory figures, the auditor should presume there was no net change in inventory.

The preferred method to determine the selling price of fuel is from the taxpayer's records. When the selling prices are not available from the taxpayer's records, the next best source would be the U.S. Energy Information Administration (EIA). (https://www.eia.gov/petroleum/gasdiesel/)

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In the case of limited/missing records, the auditor may also observe what products are being sold and circulate potential vendors to get a record of what purchases were made. This is discussed in greater detail in the "Investigative Tools" section in this chapter.

10.5.3 Margin And Mark-Up

Many people in business mistakenly assume margin and mark-up percentages are the same. This may result in a business failing to make an expected profit because the mark-up percentage is always greater than the margin percentage. While they may tell the auditor they have a 50% mark-up percentage, they may actually have a 50% margin percentage. Before relying on a percentage given by the taxpayer, the auditor needs to verify how the taxpayer arrived at that percentage to avoid confusion. Confusion is not unusual because mark-up and margin expressed in dollars are identical.

In many cases, people often refer to "mark-up percentage" and "margin percentage" as simply "mark-up" and "margin". In addition, people often refer to the "mark-up factor" as just "mark-up". This is commonly done because the number format identifies the type of mark-up or margin. A dollar value indicates a basic mark-up or margin, a percentage indicates a mark-up percentage or margin percentage, and a simple decimal number indicates a mark-up factor. This can lead to confusion for people who may only have minimal experience with retail accounting. When preparing the audit narrative, it is important for the auditor to clarify what is meant by these terms.

The mark-up factor applied to a taxpayer's purchases is generally something the auditor will need to calculate. To do so, the auditor needs to understand the meaning of some key terms.

Mark-up – The basic profit in a sale expressed in dollar terms is referred to as the "mark-up", "margin", "gross margin", or "gross profit". If a taxpayer purchases an item for $100 and sells it for $150, the "mark-up", "margin", "gross margin", and "gross profit" are all $50:

Mark-up (margin, gross margin, gross profit) = Selling Price – Cost

$50 = $150 - $100

The basic profit percentage of a sale is expressed in two ways: mark-up percentage and margin percentage. Although, "mark-up" and "margin" are the same, "mark-up percentage" and "margin percentage" are not.

Mark-up Percentage is the percentage difference between the actual cost and the profit.

The mark-up percentage expresses the profit in a sale based on the cost of the product. For the same sale, the mark-up percentage will always be higher than the margin percentage.

Mark-up Percentage = (Selling Price – Cost) / Cost x 100%

For example: A taxpayer purchases $100 worth of inventory and sells it for $150. The mark-up/margin is $50. The mark-up percentage is 50%:

Mark-up % = ((Selling Price – Cost) / Cost) x 100%

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Mark-up % = (($150 - $100) / $100) x 100%

Mark-up % = ($50 / $100) x 100%

Mark-up % = .50 x 100%

Mark-up % = 50%

Mark-up Factor – The mark-up factor is used to apply the mark-up percentage more easily to taxpayer purchases. It is equal to the mark-up percentage divided by 100% +1. For example, a mark-up percentage of 50% results in a mark-up factor of 1.5:

Mark-up Factor = (Mark-up percentage / 100%) + 1

Mark-up Factor = (50% / 100%) + 1

Mark-up Factor = .5 + 1

Mark-up Factor = 1.5

Margin Percentage is the percentage difference between the selling price and the profit.

The margin percentage expresses the profit in a sale based on the selling price of the product. For the same sale, the margin percentage will always be less than the mark-up percentage.

Margin Percentage = ((Selling Price – Cost)/Selling Price) x 100%

For example: A taxpayer purchases $100 worth of inventory and sells it for $150. The mark-up is $50. The margin percentage is 33.3%.

Margin % = ((Selling Price – Cost) / Selling Price) x 100%

Margin % = (($150 - $100) / $150) x 100%

Margin % = ($50 / $150) x 100%

Margin % = .333 x 100%

Margin % = 33.3%

Selling price covers the cost of merchandise plus all overhead expenses and net profit. The selling price is always 100 percent because it is the total amount of money the seller is going to get from the sale. Margin percentage is always figured on the selling price. It is a percentage of sales.

Mark-up vs. Margin Chart

15%	Mark-up	=	13.0%	Margin
20%	Mark-up	=	16.7%	Margin
25%	Mark-up	=	20.0%	Margin
30%	Mark-up	=	23.0%	Margin
33.3%	Mark-up	=	25.0%	Margin

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40%	Mark-up	=	28.6%	Margin
43%	Mark-up	=	30.0%	Margin
50%	Mark-up	=	33.0%	Margin
75%	Mark-up	=	42.9%	Margin

100% Mark-up = 50.0% Margin

Mark-up Factor using Industry Averages – Risk Management Association (RMA)

Another way to determine the Mark-up Factor is to use a published industry average. An example is the Risk Management Association's (RMA) Annual Statement Studies: Financial Ratio Benchmarks. It is compiled using balance sheet and income statement data from customer statements submitted to member organizations. The data is separated by NAICS code and by sales totals.

The most used ratio when conducting an audit is the Gross Profit Ratio which is equal to the Net sales minus the Cost of Sales (also referred to as Cost of Goods Sold). This is the basic profit on the sale of an item before considering non-product expenses such as wages, rent, utilities, etc. In the RMA, the Gross Profit is expressed as a percentage of net sales and can be used to calculate the expected mark-up using the following formula:

Mark-up Factor = 100 / (100 – Gross Profit)

Example: A liquor store has a listed Gross Profit of 20.0 in the RMA. The Mark-up Factor is calculated as follows:

Mark-up Factor = 100 / (100 – Gross Profit)

Mark-up Factor = 100 / (100 – 20.0)

Mark-up Factor = 100 / 80.0

Mark-up Factor = 1.250

When using RMA to calculate the mark-up, purchases should NOT be separated into categories and no allowances for spillage or spoilage should be considered.

10.5.4 Limitations

Although the percentage mark-up method may be useful for determining or verifying sales when records are inadequate, judgment should be exercised to make sure the comparisons are made for situations that are similar to those under examination. For example, make sure the comparison involves two businesses that are of similar nature, size, inventory, and location. The mark-up information for a convenience store may be too different to use for a tobacco store. The best information available should always be applied. Some of the factors to consider in making these comparisons are as follows:

- Type of merchandise handled - for an auditor to make a proper comparison, the business must be dealing in the same type of merchandise or service. The comparison of the gross profit of a restaurant to that of a grocery store would be of little value and should not be used.

- Size of operation - In many instances gross profit, cost of doing business, and net profit percentage on sales will vary according to the size of a business. This is especially true with respect to expense items and the net profit as compared to sales. The percentage of net profit

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to sales of a large department store would vary considerably from the small independently owned general store.

- Locality - This factor must be considered in determining a typical ratio for this type of computation. Mark-ups and cost of operations will normally vary to a certain degree according to the size of the city or the business location.

- Period covered - Since gross profit ratios and expense ratios will tend to vary year to year due to economic conditions, the comparison should normally be made to similar periods covered by the examination.

- General merchandising policy - Percentage comparison should not be made between businesses having different merchandising policies. Some businesses may work on large volume with a small mark-up, offering the customer little service; others may operate on the reverse policy. In situations of this kind, comparisons should be made only to those businesses having similar merchandising policies.

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In many instances, gross receipts may be determined or verified by applying price and profit figures to the known or ascertainable volume of business conducted by the taxpayer. This method is feasible when the auditor can establish the number of units handled by a taxpayer and the price or profit charged per unit. In certain instances, it may be possible to determine the number of units sold or volume of goods sold by a taxpayer from their books and records. The taxpayer's records may be adequate to determine the cost of goods sold or expenses.

The use of this method lends itself to those businesses in which only a few types of items are handled or there is little variation in the types of items sold. It is important that the pricing of the merchandise being sold is relatively constant throughout the period examined. A relatively modest percentage of change in pricing from year to year by the taxpayer would be considered the same throughout the period examined. A constant inventory purchased indicates that items purchased are being sold. This method may be used on many types of businesses, however; it is most reliable and accurate in audits of liquor stores and taverns where purchases of liquor, beer and wine are only from wholesale distributors within a localized area.

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The preferred method to determine the mark-up is from either the selling prices obtained from the taxpayer or the selling prices at the taxpayer’s business. When those are not available, the next best source would be the Risk Management Association’s (RMA) Annual Statement Studies: Financial Ratio Benchmarks. The auditor must consider when only partial records are available if there is enough information provided by the taxpayer to calculate a mark-up.

When there is not enough information available, the RMA mark-up method is an accepted practice for marking up sales based on the taxpayer’s purchases. On RMAHQ.org the auditor can find descriptions for the correct type of taxpayer being audited and then the mark-up can be applied. The RMA gross profit is an all-encompassing number. Therefore, when RMA is used to calculate the mark-up, purchases should not be separated into categories (i.e., cigarettes or alcohol should not be separated out from other convenience store purchases) before applying the mark-up.

Example: A liquor store has a listed Gross Profit of 20.0 in the RMA. The Mark-up Factor is calculated as follows:

Mark-up Factor = 100 / (100 – Gross Profit)
Mark-up Factor = 100 / (100 – 20.0)
Mark-up Factor = 100 / 80.0
Mark-up Factor = 1.250

With gas stations, this mark-up number would be multiplied by the gas station’s purchases of convenience store items and repair parts if applicable. The fuel sales of the gas station should still follow the method above using the EIA.gov average price times the fuel gallons purchased. This is the case because a gas station receives its primary income from the convenience and repair sales, with very little profit coming from its sales of fuel.

When using the RMA figures, make sure the Central figures are used, where applicable, to be as fair to the taxpayer as possible. When it is not clear what a taxpayer’s business is operating as and the auditor needs to determine what mark-up to use, they should check the taxpayer’s NAICS code to determine the type of business and the corresponding mark-up to use.

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Areas of special interest to auditors when auditing businesses with limited records are the comparison of low-rate sales to high-rate sales, SNAP (i.e., food stamps, Link Cards), lottery sales, and WIC (Women, Infants, and Children) cards.

10.8.1 High rate vs. Low rate

To conduct this examination, percentages of high and low-rate purchases should be established. This test can be conducted using one year of purchase invoices. These percentages of purchases should then be compared to the percentage of sales reported for reasonableness. If the taxpayer can demonstrate that they are collecting tax at the low rate through a test of their POS, then an allowance should be made based on the best information available.

Additionally, if the taxpayer claims that sales are paid for by food stamps, this amount should be added to low-rate sales and the total of the two should then be compared to total low-rate purchases. The reason for this comparison is that only food sales can be paid for with food stamps and thus the low-rate sales might be double counted.

10.8.2 Other Resources

The SNAP benefits (previously food stamp/link card) deduction must be verified by obtaining verification from the Department of Agriculture. The request should include the name and address as well as the period that must be verified.

Be aware of how the taxpayer treats their sales of lottery tickets. They could be eliminated from ST-1, Line 1 but included in, Line 1 of the Federal Income Tax return or included in ST-1, Line 1 and taken as a deduction. No matter how the taxpayer treats their lottery sales, these amounts need to be verified. One way is by reviewing statements from the Lottery Department. Another way is by reviewing the electronic deposits included in the taxpayer's bank deposits.

The WIC deduction must be verified by obtaining verification from the Illinois Department of Human Services. The request should include the name and address as well as the period that must be verified.

Note: For the most up-to-date contact information for the Department of Agriculture, Lottery Department, and Department of Human Services, please contact Technical Support.

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Due to the investigative nature of audits that do not have adequate records, the audit does not necessarily end when traditional examination procedures are concluded. The following is a list of investigative tools that MAY be used in any given audit. This list, however, is not comprehensive, and additional tools may be used. Additionally, this list is NOT MEANT AS A LIST OF REQUIRED PROCEDURES. The decision to use any of these procedures is reached on a case-by-case basis.

Visual Observation: Because it is the most obvious tool, it is probably the most overlooked. Observations can point out many possible discrepancies in books and records.

For example, a restaurant lists alcoholic beverages on its menu, but the records show only food sales. This is potentially a good area to discover unreported receipts. Or, if the business has days of operation posted as seven days a week and records show only five days of sales, this again can indicate unreported receipts.

Keep in mind that often casual observations can develop into a starting point for an area of investigation.

Federal Income Tax Return: Line 1 of the US-1120, 1120S, 1065 or 1040 (Schedule C) should be analyzed to determine how this figure has been arrived at and what the components of this figure are. Is the taxpayer able to support this entry with documentation?

Review of the entire federal return will provide major insights for the audit regarding determination of cost of goods sold, mark-up, and wages. For example, if there are employees working at the business, the federal return should show wage expenses.

Circularizing Vendors: When the 1099-K statement is not available and/or the taxpayer is purely a cash business, which does not accept payment cards, vendors may be circularized.

EDA-20s should be used to circularize vendors. By sending EDA-20s, the auditor is verifying the purchases made by the taxpayer. It is important to include all vendors, not just selected ones, when circularizing. This is especially true if conducting a joint audit with Criminal Investigations or when working a referral from Criminal Investigations. The following EDA-20s are available in the Department's audit software:

- EDA-20-M – Request for Verification of Merchandise Sold Tax-Free
- EDA-20-G – Request for Verification of Motor Fuel Sold for Resale
- EDA-20-S – Request for Verification of SNAP Redemptions
- EDA-20-C – Request for Verification of Merchandise Purchased

Please see the audit supervisor for a copy of the current supplier list. It is important to remember that these suppliers are doing the Department a favor by supplying third-party records. To continue to have a productive and cooperative relationship with these vendors, auditors must remain professional and not become overbearing.

Liquor Distributors are useful when auditing a business that serves liquor or sells packaged liquor. As liquor laws require these businesses to buy from a limited number of liquor distributors, they are an excellent source for establishing purchases or verifying cost of goods sold.

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Subpoenas may be issued by Legal Services, as needed. The subpoenas can be used to elicit information, not only from vendors, but also documentation from other third-party sources, such as landlords, credit card companies, banks, accountants, etc.

Criminal Investigations Division (CID) is a resource for audits with limited or potentially unreliable documentation. This resource is useful as different investigative options are available in different situations. Additionally, CID should be included in clear cases of fraud.

Liquor Control Commission is another resource for the audits with limited or unreliable records. This resource is useful if the taxpayer is being uncooperative in providing invoices or price lists.

Internal Revenue Service (IRS) is another source for assistance as they can delve into many areas of personal income that IDOR is not used to addressing. To involve the IRS in a case will usually involve a joint audit. To arrange for a joint audit, contact the audit supervisor who will make appropriate contacts with the IRS.

Illinois Department of Employment Security (IDES) information can be used to verify employment. Employment verification helps determine sources of income. For example, if the taxpayer is earning little or no income from the business, IDES can provide information to support a standard of living by establishing a spouse's income.

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10.10.1 Assessing Tax on Liquor & Referrals to ILCC

When auditing a business that sells alcoholic liquor, auditors must be aware of laws established by the Illinois Liquor Control Act that makes it illegal to give away alcoholic liquor. This is enforced by the Illinois Liquor Control Commission (ILCC). The Illinois Liquor Control Act states,

> "'alcoholic liquor' includes alcohol, spirits, wine and beer, and every liquor or solid, patented or not, containing alcohol, spirits, wine or beer, and capable of being consumed as a beverage by a human being. The provisions of this Act shall not apply to alcohol used in the manufacture of denatured alcohol produced in accordance with Acts of Congress and regulations promulgated thereunder, nor to any liquid or solid containing one-half of one per cent, or less, of alcohol by volume. No tax provided for in Article VIII of this Act shall apply to wine intended for use and used by any church or religious organization for sacramental purposes, provided that such wine shall be purchased from a licensed manufacturer or importing distributor under this Act."

Regulation section 11 Ill. Adm. Code 100.280, Giving Away of Alcoholic Liquors, states no licensee, individual, partnership or corporation is allowed to give away any liquor for commercial purposes or in connection with the sale of non-alcoholic products or to promote the sale of non-alcoholic products. However, section 11 Ill. Adm. Code 100.285 provides procedures, that when followed, allow retailers to partake in test marketing, tastings, and product samplings without being in violation of the Liquor Control Act.

For example, during the course of an audit it is discovered that the taxpayer's books and records show "liquor comps" or "beer comps". This situation may be a violation of the Liquor Control Act. The auditor should verify with the taxpayer that the "liquor comps" or "beer comps" are alcohol given to customers or employees after their shift has ended, and that they are not alcohol purchased by the taxpayer for their customers or employees.

Even though it is a violation for liquor to be given away, there is nothing in the Liquor Control Act that prevents an employee or owner from purchasing liquor for a customer. However, an actual recorded sale must take place for an employee or owner to be considered to have made the purchase. An owner cannot claim to be paying for the liquor from their lost profit.

While it is a violation of the Liquor Control Act for liquor to be given away, it is not in violation of the Retailers' Occupation Tax Act ("ROTA") or Use Tax Act ("UTA") for a retailer to give away or donate tangible personal property (TPP). However, the retailer makes a taxable use of TPP when giving an item away. According to 86 Ill. Adm. Code 150.305, the donee in a gift situation is not the taxable user, however, the donor who made the purchase and gave the item away is the one who makes a taxable use of the property given away. Therefore, the donor owes Use Tax (UT) on their cost of the property that was given away. There is nothing in the Retailers' Occupation Tax (ROT) Act, UT Act, or regulations that differentiates liquor from any other tangible personal property.

The ILCC is a separate and distinct entity from the Illinois Department of Revenue and is responsible for enforcing the rules in the Liquor Control Act. Sales and excise tax auditors are responsible for enforcing the law according to the ROT and UT acts. The fact that giving away alcohol violates the

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Liquor Control Act does not change the manner in which the Audit Bureau enforces the ROT and UT acts. Below are the actions auditors should take with regards to potential alcohol giveaways:

- If a retailer has reliable books and records or other evidence verifying liquor was given away or donated, then UT is due on these items. The auditor should assess UT on the retailer's cost for any of these exceptions found in the audit.

- If a retailer has reliable books and records or other evidence showing liquor was sold (whether to a customer, employee, owner, etc.), then ROT is due on these transactions. The auditor should assess ROT on the selling price of the TPP for any of these exceptions found in the audit.

- If a retailer does not maintain or provide books and records to show liquor was given away, or it is determined the books and records provided are not reliable; then ROT is due on these transactions. The auditor should assess ROT on the selling price of the liquor for any of these exceptions found in the audit. Auditors should not accept a verbal statement from a retailer in place of documentation when verifying any deductions claimed by a retailer. If a retailer is unable to provide documentation to verify an item was given away or donated, then the auditor is not to assess UT on those exceptions.

10.10.2 Indications that a Referral to ILCC is Necessary

- Books and records show liquor is given away (excluding liquor given away or donated to not-for-profit organizations or Special Event Retailer Licensees);

- Books and records do not show liquor is given away, but the retailer states in writing that they have given liquor away (excluding liquor given away or donated to not-for-profit organizations or Special Event Retailer Licensees);

- There is an indication that liquor was purchased from another retailer (i.e., Sam's, Costco, Jewel, Wal-Mart, Binny's, etc.);

- Liquor purchase receipts are from a source other than a licensed distributor (the status of liquor licenses for distributors, wholesalers, and retailers can be found on the ILCC website, https://www2.illinois.gov/ilcc/resources/Pages/Liquor-License-Lookup.aspx);

- There is an indication that liquor sales do not match the retailer's liquor purchases or stock; or

- There is an indication or admission from the retailer that the liquor on hand was transferred from another location (i.e., an off-site warehouse, another commonly-owner retailer, etc.).

10.10.3 How to Refer a Retailer to the Illinois Liquor Control Commission

To refer a retailer to the ILCC, auditors should complete an EAR-19, including any applicable documentation, and submit it to their supervisor. If the supervisor agrees with the referral, the supervisor should send the EAR-19 and attachments to the ILCC Enforcement Division Investigations Supervisor. Contact Technical Support for the most up-to-date contact information.

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