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Internal Revenue Manual Section 4.10.4.6.4 (05-27-2011)

Bank Deposits and Cash Expenditures Method

1. An important feature of any examination is the inspection or analysis of the taxpayer's bank records. This is particularly so in the examination of inadequate, nonexistent or possibly falsified books and records. The depth of the bank account analysis (see *IRM 4.10.4.3.3.7*) will depend upon the facts and circumstances of the individual case. When the bank account analysis indicates a reasonable likelihood of unreported income, the examination of income may be expanded to include the use of the formal Bank Deposits and Cash Expenditures Method to determine the actual understatement of taxable income.
2. In summary, income is proven through a detailed, in-depth analysis of all bank deposits, cancelled checks, currency transactions, and electronic debits, transfers, and credits to the bank accounts AND identification of the taxpayer's cash expenditures. The Bank Deposits and Cash Expenditures Method is distinguished from the Bank Account Analysis by:
 - A. The depth and analysis of all the individual bank account transactions, and
 - B. The accounting for cash expenditures, and
 - C. Determination of actual personal living expenses.
3. The Bank Deposits and Cash Expenditures Method computes income by showing what happened to a taxpayer's funds. It is based on the theory that if a taxpayer receives money, only two things can happen: it can either be deposited or it can be spent.
4. This method is based on the assumptions that:
 - A. Proof of deposits into bank accounts, after certain adjustments have been made for nontaxable receipts, constitutes evidence of taxable receipts.
 - B. Outlays, as disclosed on the return, were actually made. These outlays could only have been paid for by credit card, check, or cash. If outlays were paid by cash, then the source of that cash must be from a taxable source unless otherwise accounted for. It is the burden of the taxpayer to demonstrate a nontaxable source for this cash.
5. The Bank Deposits and Cash Expenditures Method can be used in the examination of both business and nonbusiness returns.
6. The Bank Deposits and Cash Expenditures Method may supply leads to additional unreported income, not only from the amounts and frequency of deposits, but also by identifying the sources of such deposits. Determining how deposited funds are dispersed or

accumulated (to whom and for what purpose) might also provide leads to other sources of income.

7. If the Bank Deposits and Cash Expenditures Method indicates an understatement of taxable income, it may be due to either underreporting of gross receipts or overstating expenses, or a combination of both.