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Bank deposits analysis upheld

The Tax Court rejects a taxpayer's claim that the IRS's reconstruction of his income included nontaxable proceeds from a real estate sale.

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The Tax Court approved the IRS's application of the bank deposits method to establish the amount of a taxpayer's additional unreported business income.

Facts: Richard Showalter was the sole owner of Real Estate Consulting Services (RECS), a single-member limited liability company (LLC) treated as a sole proprietorship for tax purposes.

Showalter did not file an individual income tax return for 2013. The IRS, based on information submitted by third-party payers, prepared a substitute for return to calculate Showalter's gross income under Sec. 6020(b). The Service determined that Showalter received income of $367,977 during 2013, which consisted of $367,103 of business income from RECS, $833 of gambling winnings, and $41 of interest.

The IRS calculated a resulting income tax liability of $122,857, plus additions to tax for failure to file and pay, plus estimated tax penalties.

In 2019, after petitioning the Tax Court for a redetermination, Showalter and the IRS stipulated to the amount of unreported income in the deficiency notice, including the $367,103 of business income received by RECS, which consisted of two payments reported on Form 1099- MISC, *Miscellaneous Income*. After the government subpoenaed RECS's bank records, the parties further stipulated that Showalter was entitled to $199,958 of business deductions and $50,652 of itemized deductions. Showalter conceded any tax liability related to self-employment income from RECS and the additions to tax.

However, after using a bank deposits analysis to examine the total deposits in RECS's bank account, the IRS determined that Showalter had additional unreported business income of $102,885, which became the only remaining point of contention between the parties. Showalter contended that the IRS failed to exclude a nontaxable deposit of $95,002 related to a real estate transaction in its calculation of the additional unreported income.

In 2022, the IRS moved for partial summary judgment by the Tax Court.

Issues: If a taxpayer does not keep accurate books and records establishing gross income, the IRS may determine it under a prescribed method that clearly reflects income (Sec. 446(b); *Petzoldt*, 92 T.C. 661 (1989)). One such method is a bank deposits analysis. In reconstructing income, the IRS "need only be reasonable in light of all surrounding facts and circumstances," the Tax Court stated, citing *Petzoldt*.

The Tax Court further stated that the bank deposits analysis presumes that any money placed in a taxpayer's bank account is taxable income unless the taxpayer proves otherwise. According to the court, nontaxable income may come in the form of interaccount transfers; returned checks; and loans, gifts, inheritances, or assets on hand at the beginning of the tax period.

Holding: The court held that the IRS properly performed its bank deposits analysis and sustained the IRS's determination of $102,885 of additional unreported income for 2013.

Showalter's sole contention was that, in using a bank deposits analysis, the IRS did not consider the nontaxable real estate transaction. However, the IRS, when conducting its analysis of the account, subpoenaed the closing documents from the sale on Aug. 6, 2013, which showed cash due to Showalter of $95,002. This amount matched exactly a deposit made to RECS's account, which the IRS properly subtracted from RECS's bank deposits, the court held. Thus, the IRS's calculation of the Showalters' additional unreported income was correct.

■ *Showalter*, T.C. Memo. 2022-114

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