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Preventing Tax Filing Frauds in the Used Automotive Sales Industry

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UNIVERSITY OF NORTHERN IOWA

Department of Industrial Technology

Research Paper

PREVENTING TAX FILING FRAUDS IN THE USED AUTOMOTIVE SALES
INDUSTRY

By

Nasir K. Al-Otaibi

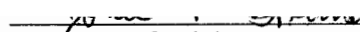
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INTRODUCTION

The history of the Internal Revenue Service (IRS) goes back to when President Lincoln and congress enacted an income tax in order to pay for the war expense in 1862. Since then the IRS has been developing laws to enforce the taxation procedures. But as known, in all advantages some disadvantages has to exist, such as fraud, money laundering and false filing report. Yet some are hard to identify or prevent due to the scam artist in the industry. In order for the IRS to stop these scams, they have established a couple of sections in their department and one of them is the section of Criminal Investigation (CI). The purpose of this section is to investigate the portion of American taxpayers who violate their duty of filling out their income tax or not paying the correct amount of tax where they pose a severe threat to the American economy. The CI section is one of the largest enforcement programs at the IRS. Investigations of people and industries in all fields and levels of business are included in it. Despite all of these efforts to stop the taxation fraud there still are scam artists that can break the laws without getting caught (US IRS, 1993).

Statement of the Problem

The research problem is to improve the tax reporting process that will help prevent tax fraud in the used automotive sales industry. Car dealers might not fill out the right tax information on the IRS tax forms nor file any taxes at all. These kinds of problems could affect the economy of the whole country. In particular the car buyers who are paying tax to the dealers and the dealers could keep the money in there pockets (IRS, 2005).

Purpose of the Study

The purpose of this study is to provide the department of treasury and the taxpayers in the automotive sales industry with an improved system designed to stop tax frauds in all cash transactions. The system will give the opportunity for the tax payers to participate in filing the

amount of tax that they paid to the dealer to the IRS before getting the license plate and registration of the car.

Need / Justification

The need and justification of this study is based on the following factors:

1. According to the IRS the number of taxpayers that are breaking the tax laws is as high as 17 percent (Fraud and Tax Crime, 2004).
2. In an article with the titled, *A Hamburg auto dealer charged with failing to pay \$574,000 in sales taxes*, revealed the great problem of tax fraud in the car industry (Western New York's Business Newspaper, 2002).

These are some of many facts that explain why an improved system needs be developed in the department of treasury to prevent scams. More effective methods have to be found in order to protect the tax payers from frauds by the car dealers who are not reporting the customer's taxes to the IRS.

Research Questions

The following research questions were addressed during the course of this research project:

1. What is the importance of preventing tax fraud in the used automotive cash flow sales industry?
2. What weaknesses does the IRS information and management system have in their database system?
3. What are the rights and penalties of the taxpayers when they are not complying with taxation while dealing with the used auto sales industry?
4. What benefits in terms of time and money could the IRS gain if an improved system (as suggested in this paper) was established?

Assumptions

The assumptions of the study are noted as follows:

1. Collecting data from several official government websites and documentations to provide the best information about cash flow taxation process in the auto sales industry.
2. Collecting data by observing a small car shop and the process of filing sales tax to the IRS by the car dealer when a used car is sold in a cash transaction.
3. Investigating the process of the IRS information and management system by collecting data from texts and government website.

Limitations

The limitations of the study are noted as follows:

1. Accurate identification of tax fraud in the IRS information system is dependent on the IRS criminal investigation division website.
2. Accurate identification of the IRS management systems within the study is dependent on the accuracy of the department of treasury website.

Statement of Procedures

This project will identify the original IRS information and management system and its weaknesses by collecting data from government websites and observing the used car taxation process. After analyzing the data collected and dividing them to entities and attributes one can figure out the relations between them, then by transforming the data collected to an entity relation diagram (ERD) it will be easy to identify the linkage and the weakness of the current system and its primary keys. Finally, after identifying the weakness one can add an extra entity to the diagram to prevent any weakness in the system.

This project will also propose an improved information and management system which could prevent tax fraud in the used automotive industry. The information system will

function by comparing the amount in the car dealer's tax receipts with the customer's receipts. It would also alert the IRS and put them on the watch list if the tax amounts are not the same or if the customer and the dealer had more than three transactions together. The project would concentrate on the cash flow transactions in a trade or business and the false report statements that are submitted by the auto dealer to the IRS when filing their tax returns.

Definition of Terms

The following terms used in this study, although not unique, were defined so that all readers may have a common understanding of their use within this study.

IRS

Internal Revenue Service, it is governmental department that handle all the tax work in the country from collecting the taxes to protecting it (US IRS, 2000).

CTR

Currency Transaction Report or as called form 4789 is a form that should be filed out by the Financial institution reporting any deposit in the amount of \$ 10,000 or more to the IRS(US IRS, 2000).

STR

Suspicious Transaction Report, it is a form that is filed by the financial institution reporting any suspicious deposit of \$5,000 or more to the IRS (US IRS, 2000).

Form 8300

Report of Cash Payments over \$10,000 Received in a Trade or Business. This form should be filed by the car dealer and reported to the IRS (US IRS, 2000).

Money laundering

The act of trying to convert money or property gained from illegal activities to money that will appear to have been legally earned (US IRS, 2000).

(CI)

Criminal Investigation division, a department located at the IRS that is in charge of deducting any illegal activities such as false filing or evading taxes and prosecutes (US IRS, 2000).

False Filing

The act of filing the wrong information on the income tax report in order to save money on the tax return (US IRS, 2000).

Evade Tax

Evading taxes is the act of not reporting or filing the taxes report (US IRS, 2000).

Car Jacket

It is the paper work that has all the information about the car such as model, year and make that usually the car dealer keeps for every car (US IRS, 2000).

Curbstone

Are the car dealers who have no license from the government to trade cars, they buy and sell cars by listing it in newspapers or parking lots (US IRS, 2000).

LITERATURE REVIEW

This literature review will give an over view of the used car industry, used car dealer scams and the penalties that an automotive dealer will face if convicted of scams. In addition, it will explain the different ways of keeping car records, accounting and sales taxes done by the dealer. Finally it will explain the tax payer's rights and the IRS information and management system weaknesses.

The Used Car Industry

One of the profitable industries in the United States is the used car industry. Most of the big car companies such as Ford, Buick, GM and Cadillac make their profit by building and selling new cars to small dealerships that then sell them to customers. On the other hand, the

used car industry such as any industry has a lot of business practices, and to be a successful dealer in this industry one must understand automotive business practices.

The used car industry is divided into two major categories. The first is the car dealer who sells new or used cars and has a state license to practice the business; he/she accepts trade-ins and also is affiliated with an automaker. The second category is the independent car dealers, commonly known as curbstones who independently sell used cars. Their basic goal is to buy and sell as many used cars as they can. They probably don't have a shop or a state license which could make it difficult for the state to track illegal income. They can do their business by listing cars in parking lots or in newspapers (IRS, 2005).

From the year 2000 to 2003, the IRS has witnessed an increase in fraud and scams in the automotive industry. The scams included money laundering or submitting false information on the business tax forms. IRS Criminal Investigation agents have inspected and informed the Department of Justice of many suspects of fraud in the automotive sales industry (US IRS, 2003).

Used Car Dealer Scams

The criminal investigation division at the IRS has been investigating the automotive industry. Form 8300 is an official form that should be filled out by the car dealer and sent out to the IRS if he/she received cash money in the amount of \$10,000 or higher. Between year 2000 and 2003 out of 280 cases investigated by the IRS on people involved in automotive industry, 15 percent were found to have broken rules in reporting money transactions on the Form 8300 (US IRS, 2003).

The United States Attorney's Office filed twice as many tax fraud cases observed in the automotive industry the first six months of the fiscal year of 2003 as in 2002. The average jail time for these crimes also rose from 38 months to 55 months (US IRS, 2003).

	FY 2000- 2002 Totals	FY 2002 (10/01- 5/31)	FY 2003 (10/01- 5/31)
Initiations	219	54	65*
Prosecution recommendations	146	22	35
Indictment/information filed	145	19	38
Convictions	136	29	18
Sentenced	155	34	22
Incarceration rate	78.9%	61.8%	72.7%
Avg. months to serve (w/prison)	37	38	55
Avg. months to serve (all sent)	32	24	40

Note. The information presented is not always similar to the one shown in the fiscal year since certain investigations may exceed fiscal years. Consequently, the high number of investigations, trials, suggestions and accusations by the IRS in 2003 should result in more convicted criminals in 2004 (US IRS, 2003).

Penalties

The following is the United State Code Status recommended by the IRS authority to prosecute people involved in the automotive industry.

- Title 26 USC Section 7201, attempt to evade or defeat tax;
- Title 26 USC Section 7203, Willful failure to file return, supply information, or pay tax;
- Title 18 USC Section 1956, Laundering of monetary instruments;

- Title 18 USC Section 1957, Engaging in monetary transactions in property derived from specified unlawful activity;
- Title 31 USC Section 5324, Structuring transactions to evade reporting requirement.

Convictions on any of the titles above is a criminal act and could result in a sentence up to 20 years in prison, except of Title 26, 7203 (US IRS, 2003).

Keeping Car Records

Most of the laws and records regarding sales of used cars differ from state to state, however there are some federal laws such as the Federal Truth in the mileage Act that all car dealers should list in their records the mileage on their cars from the odometer (IRS, 2005). There are no general computers accounting software designs by the IRS for independent car dealers. On the other hand, many different programs are available on the markets that are used by the car dealers (IRS, 2005).

There is a separate file which is usually called a car jacket that should be filled with any purchased automobile and assigned a stock number, which makes it easier to track the cost of the vehicle. For cash sales the car jacket information usually includes:

1. Order of retail buyers and sales (unit number)
2. Buyer's information such as first name, last name, address and identification number
3. Price of sales
4. Taxation of sales (sales tax differ from state to state)
5. Filing and documentary fees
6. Federal and state disclosure statement
7. Vehicle stock number
8. Form 8300, if applicable

Receipts of all transactions are usually recorded by the car dealer on a daily basis.

Usually, the dealer has a direct deal with the buyer, another dealer or a wholesaler. Payments are commonly made by checks, bank loans or a credit card which makes it easy tracking accounts if there was any mistake. Another way of payment is through cash. The dealer is only required to fill out Form 8300 if the cash payment is over \$10,000 (IRS, 2005).

Accounting and Sales Taxes

Generally, small used car dealerships are owned by an independent individual or it is a family business. Small dealerships are found to be prone to poor methods of keeping records of accounting. Likewise, car dealers on a national scale have been found to be using incorrect ways of bookkeeping (IRS, 2005). To try to prevent improper accounting methods the IRS section 466(c) permits ways of bookkeeping for calculating taxable earnings (IRS, 2005).

The IRS requires car buyers to pay car dealers a sales tax, registration and license fee on all retail sales, which in turn will be paid to the state by the dealer. On the other hand not all car dealers comply with this law, especially independent used car dealers because it is hard for the IRS to keep track of their internal records and business accounts if they don't deposit the tax money (IRS, 2005).

Tax Payer's Right

Tax payers in the United State of America, according to the IRS, have an important right, the right of privacy. The information that is given to the IRS by the taxpayers will not be revealed to anyone except by the authority of the IRS. They also have the right to know why they have been asked for information and how to be used, and the penalties for not providing accurate information by the IRS. Tax payers also have the right to be treated in a respectable and reasonable way by IRS staff. If not, taxpayers have the right to report abuse to IRS supervisors or directors. Tax payers also have a right to pay taxes in monthly payments (US IRS, 2000).

The IRS Information and Management System Weaknesses

The IRS has weaknesses in their information and management system that provides opportunities for dishonest people to commit fraud. The United States Government Accountability Office reported to the Committee on the Judiciary House of Representatives that, "Significant information security weaknesses exist at IRS that place sensitive financial, taxpayer, and Bank Secrecy Act data at risk of disclosure, modification, or loss, possibly without detection, and place IRS's operations at risk of disruption" (p.2, "IRS Information Security", 2005). They especially claim that the IRS does not regularly put electronic access such as user accounts, passwords and network security into practice. There were also reports of the lack in usage of a program for inspection and observance of access activity. These disadvantages put the IRS at risk even though they are improving their taxation processing system to ensure privacy, honesty and accessibility of taxpayers and Bank Secrecy Act data ("IRS Information Security", 2005).

As for the IRS management system, the misuse of the system by the IRS staff in helping their friends or relatives in filling false reports shows that there is no security what so ever in the database that the IRS is using. Some staff may access tax payer's accounts to create illegal refunds or browse taxpayer's records which are not even related to their work ("IRS Tax Administration," 1997).

Chapter Summary

By observing the IRS information and management system, and information found on the IRS official website, one could conclude that there are weaknesses which are making it easy for dishonest car dealers to get away with not filing for taxes. The major weakness is that the IRS Criminal Investigation Division is unable to keep track of car dealers who are not complying with the tax regulations. Such as those who receive cash payments from their customers and do not deposit the money in their bank accounts. The reason for most fraud is

that there are no relations between the department of treasury, the department of transportation and the customer. The problem could be solved by adding an entity, the Department of Transportation, to the IRS entity relation diagram. Where the customer would have to fill out a report after purchasing a used car and submit that report to the IRS clerk at the Department of Transportation before being issued a license plate. The new system would then compare the reports from the dealer and the information from the customers to deduct the mismatch information and alert the staff.

METHODS AND PROCEDURES

In this chapter the actual IRS information and management system process will be explained and designed in an entity relation diagram. In addition, to the reasons for an improved system and the purposed improved system to prevent tax filing frauds in the used automotive sales industry.

The IRS actual information and management system process

After viewing current documentation of the IRS information and management system, the following model (figure #1) could explain how the current system by the IRS operates when dealing with used cars and how to deduct frauds. The system starts with the customer purchasing a used car from a car dealer. The payments options are usually done by credit cards, payments such as leasing and financing or by cash payments which are most commonly used when dealing with used cars. The credit cards and payment methods involves a financial intuition such as a bank which makes it easy for anyone to keep records of transactions. On the other hand the cash payment methods are difficult to be tracked if the car dealer did not deposit the money in a bank account. After the customer pays the cash amount and taxes of the purchased used car to the dealer, the dealer returns a copy of the receipt and the car jacket to the customer. If the cash amount received by the dealer exceeds \$10,000, the dealer should

send Form 8300 to the IRS. If the car dealer deposited the money in a bank account and the cash deposit is \$10,000 or more the banks should send a report to the IRS by filling Form 4789. The IRS will compare the two reports received from both the car dealer and the bank. When a discrepancy is found the IRS will reports to the criminal investigation division to take action. If the cash amount did not exceed \$10,000 neither the car dealer nor the bank are required to report any forms to the IRS. The weakness of the current system (figure #2) is when the car dealer does not report the cash money received nor deposit the money in the bank, it is almost impossible for the IRS to keep track of the cash money that the car dealer is not filing annually to the IRS for sales taxes.

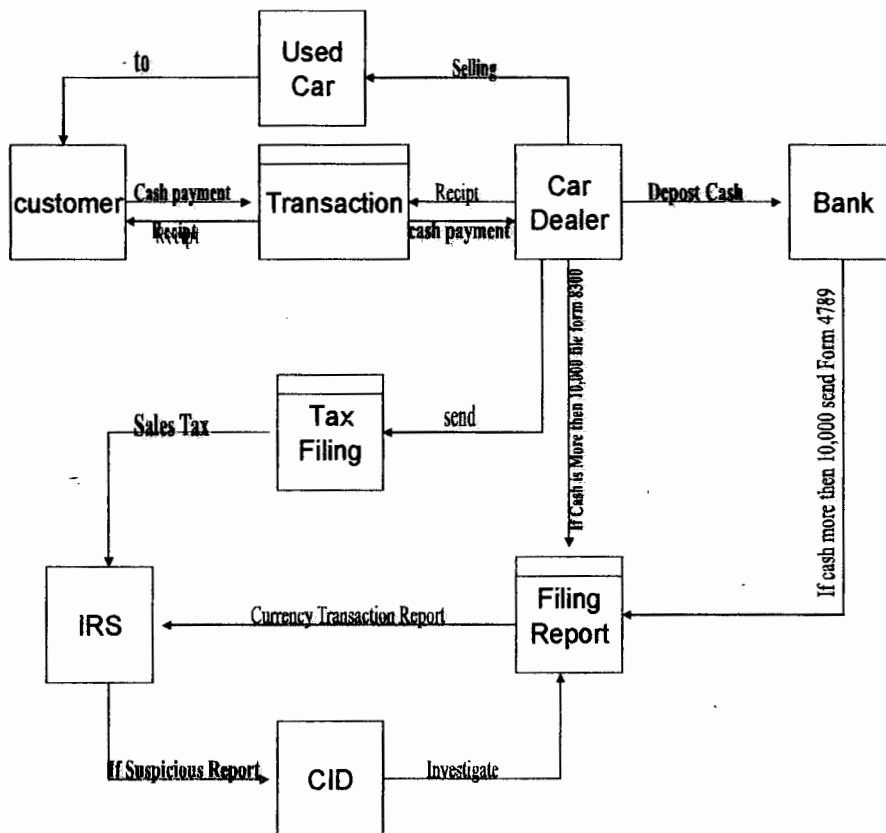


Figure #1. This Entity Relation diagram explains the current IRS information system process.

The weakness of this system is that there is no direct relation between the customer and the

IRS in order to confirm the amount of sales tax paid to the dealer if it was not deposited in a financial institution.

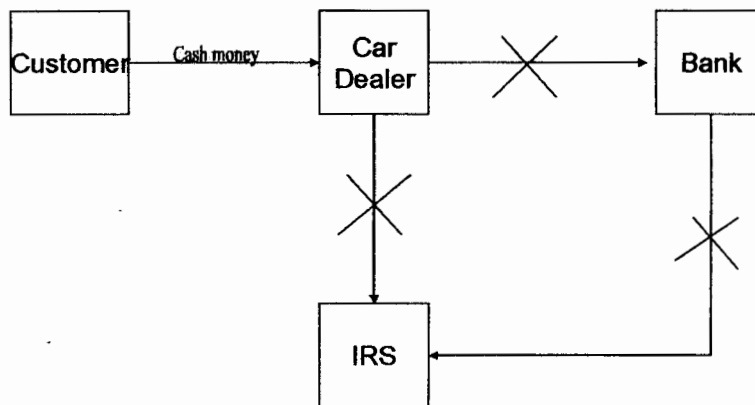


Figure #2. This diagram explains that there is no way to find out the amount of sales taxes paid in cash to the car dealer if it was not deposited in a financial institution or reported to the IRS.

The reason for an improved system

As a result of the technical problems and the design weaknesses, the current IRS system may be expensive to operate or maintain. The criminal investigation division is spending a lot of money trying to prevent tax fraud. Simple improvement to the current system would reduce the cost of money spent by the CI and it would also give a better system performance by collecting more information for their database. System improvement would give the IRS a

strong control over the information security and mishandling by the IRS clerks.

The Improved IRS Information System

By viewing the Entity Relation diagram (figure #1) one can determine that there are no relation between the customer and the IRS except for the annual tax filing. By adding an extra entity to the Entity Relation diagram which would be the Department of Transportation (DOT) and link it to the customer and the IRS entity (figure #3), the relation between the customer and the Department of Transportation would be many to one. Customers would submit a copy of the sales tax receipt from the car dealer to the IRS clerk in the Department of Transportation in order to get their car license and plates. Once the sales tax information for a used car is entered by the IRS clerk at the DOT, the car dealer's identification number as well as the sales tax amount will be sent to the IRS. The IRS improved system would compare the sales taxes on the receipt of the customer to the sales taxes on the car dealer's forms when filing for taxes each year. The system would calculate the amount of sales taxes paid by the customer to the car dealer and alert the IRS system if there was a mismatch (figure #4). The sample database has been designed and when one runs it, it will compare the data entered from the dealer and the customer and in a query it will save the mismatches records to be investigated (figures #5, 6, 7).

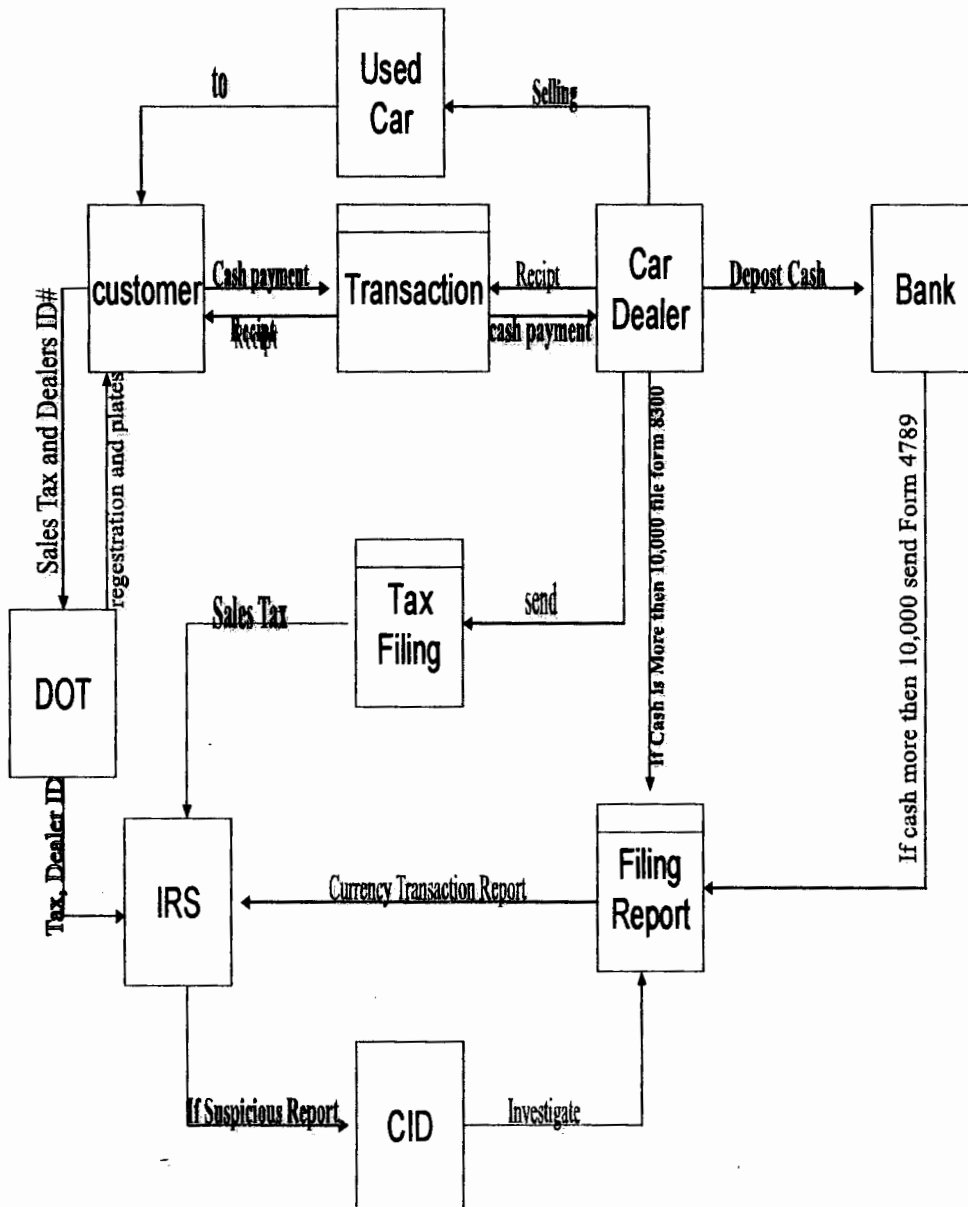


Figure #3. In this diagram one can see the added entity to the entity relation diagram, which is the Department of Transportation, where the customer submits a copy of the sales receipt before getting the registration and plates.

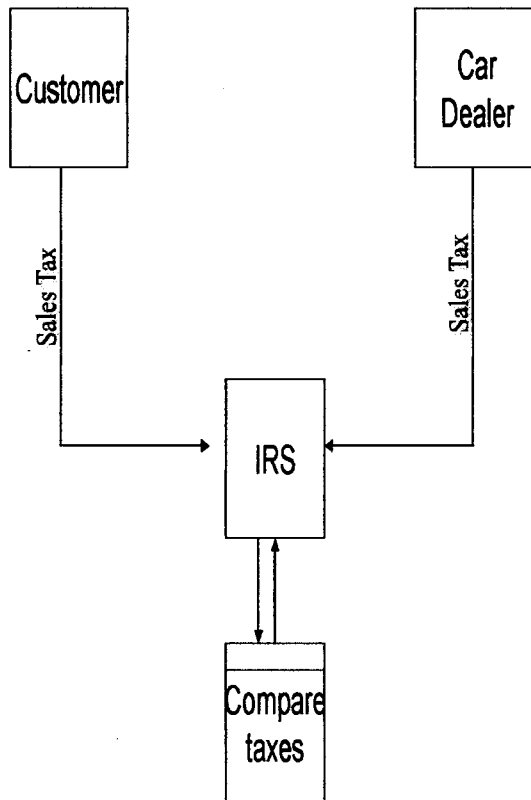


Figure #4. This diagram shows the compromising process the new system will perform after receiving the sales tax amount from both the car dealer and the customer.

Table1

Sales Tax	Sales Tax2	Customer ID	Dealer ID
\$45.25	\$50.25		1240
\$235.00	\$275.00		25
\$0.25	\$0.245		25
\$25.00	\$30.00		252
\$0.25	\$0.35		35
\$0.00	\$0.010		35
\$30.00	\$25.00		3849
\$0.25	\$0.35		52

Figure #5. This figure is a table (FORM) in the database designed in Microsoft Access, which will show a full report of all the sales taxes received by the customer and the car dealer.

Copy of Copy of Table1 Query

Sales Tax	Sales Tax2	Dealer ID
\$25.00	\$30.00	252
\$45.25	\$50.25	1240
\$30.00	\$25.00	3849

Figure #6. This figure is a copy of the form query; where the mismatch sales taxes are send to alert the IRS employee that there is a possibility of fraud.

Sales Tax

Sales Tax	Sales Tax2	Dealer ID
\$45.25	\$50.25	1240

Figure #7. This figure is a copy of the database entry form where the IRS clerk at the department of transportation will enter the sales tax information received from the customer.

CONCLUSION

The IRS information and management system is one of the most important systems in the United States of America. The percentage of fraud that occurs and the money that the IRS is spending trying to prevent these scams should be further scrutinized. According to the IRS more than 17% of tax payers are not complying with the law in one way or another (IRS, 2003). With more than 600,000 used cars sold per year and deducting 17% of tax which used car dealers are not paying one could figure out how much money the IRS is losing (NIADA, 2005). On the other hand the IRS is spending money investigating the 17% of the car dealers who are not paying the taxes. With the improved system the IRS would save a lot of money spent on the investigation division and would not allow the chance for dishonest car dealers to get away with tax fraud.

In order for the improved system to work properly the IRS should start improving some of the weaknesses in the information and management system such as:

1. There should be a relation between the IRS and the Department of Transportation. The IRS would assign a clerk in the Department of Transportation to receive a copy of the sales tax from customers and enter that information in the system.
2. An official receipt should be used by all used car dealers to report the sales tax and the car jacket.
3. The System would not allow the IRS employee to change any information in the database with out the approval of two mangers to secure unwanted changes in the system.
4. Reduce the number of employees working at the criminal investigation division to save time

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