

THIS REPORT AND ANALYSIS IS CONFIDENTIAL AND PREPARED SOLELY IN CONNECTION WITH, AND PURSUANT TO, RULE 408 OF THE FEDERAL RULES OF EVIDENCE AND IS PROVIDED ONLY AS PART OF THE ONGOING DISCUSSIONS BETWEEN THE UNITED STATES ATTORNEY'S OFFICE FOR THE EASTERN DISTRICT OF PENNSYLVANIA AND COUNSEL FOR LISA MCELHONE

Re: Lisa McElhone

Analysis of Allegations made in Paragraphs 231-242 (Pertaining to Tax Returns and Related Matters) of the Affidavit dated July 23, 2020 in Support of a Search Warrant

Description of the Assignment

Citrin Cooperman Advisors LLC ("Citrin") was engaged by counsel for Lisa McElhone ("Client") in connection with an investigation by the United States Attorney's Office for the Eastern District of Pennsylvania ("USAO") of Lisa McElhone with respect to various tax matters.

As part of that engagement counsel has requested that Citrin (1) review the portion of the Affidavit of Search Warrant (paragraphs 231 to 242) pertaining to tax returns and tax related matters; (2) identify and analyze problems with these allegations, if any; and (3) provide a report that could be submitted to the USAO as part of the ongoing dialogue, held under Federal Rule of Evidence 408, between the USAO and counsel for Ms. McElhone.

We understand that counsel has provided other information to the USAO about these matters.

Summary of Tax Return Matters and Related Allegations Included in the Affidavit of Warrant

From the Affidavit of Warrant, it appears that investigators from the IRS reviewed tax returns and tax return information of Joseph LaForte ("LaForte"), Lisa McElhone ("McElhone"), CBSG¹, and several related entities, reviewed voluminous bank records, and reviewed LaForte's and McElhone's real estate holdings. The Affidavit concludes that LaForte and McElhone may have committed tax offenses related to fraud and false statements. The following tax return and related tax matters were detailed in the Affidavit of Warrant:

1. The IRS investigators concluded that LaForte and McElhone's expenditures exceeded their reported income in tax years 2016, 2017, and 2018 by \$2.7 million, \$10.7 million, and \$1.1 million, respectively. The IRS investigators came to this conclusion by comparing the income reported on the personal income tax returns of LaForte and McElhone to the expenditures identified in various bank records and closing documents for real estate transactions².

¹ Complete Business Solutions Group, Inc.

² Per the Affidavit of Warrant, the closing documents concerned Eagle Six, Heritage, and Blue Valley Holdings

2. LaForte did not file a personal income tax return for 2016 and 2017 and had no reported sources of income despite operating CBSG.
3. McElhone filed her 2016 and 2017 personal income tax returns claiming Married Filing Separate status even though her tax liability would have been reduced by \$27,000 per year if she utilized the Married Filing Jointly status to which she was entitled.
4. LaForte and McElhone currently owe the IRS approximately \$550,000 related to tax years 2017 and 2018 even though they purchased \$33 million in real estate through various entities during this period;³ the allegation is that they had funds available to pay their outstanding personal tax liability with the IRS.
5. CBSG willfully filed false corporate income tax returns for 2015 and 2016 related to a \$10.8 million deduction for cost of goods sold in 2015 and a \$20.3 million deduction for accounts receivable purchases in 2016 in which the accounts receivables were not previously recognized as income and documentation was not provided to substantiate the deductions. CBSG also reported bad debt expense of \$300,000 in 2015 and \$5.6 million in 2016 in which the customer files provided to the agent for review did not support that the accounts were worthless. In some cases, legal remedies were not pursued and in other cases legal action was pursued, but the outcome of the proceeding was not documented in the file.

These allegations are addressed seriatim below.

Citrin's Findings and Commentary

1. Alleged Unreported Income in 2016, 2017, and 2018

A. Background Regarding the IRS Examination of Income Process

The IRS provides policies, procedures, instructions, and guidelines to its employees through its Internal Revenue Manual (“IRM”), which is the primary and official source of “instructions to staff”. Part 4 of the IRM relates to the examining process, and Part 4.10.4 specifically relates to the examination of income. Based on this section of the IRM, the minimum income probes during an IRS examination includes performing an analysis of the taxpayer’s business and personal bank accounts in order to determine unreported income.

The bank account analysis is used to (a) identify deposits which may be taxable income, (b) determine whether business expenses may have been paid from other sources (such as cash-on-hand or accumulated funds) or are overstated, (c) estimate the risk of the commingling of personal and business funds, and (d) determine whether cash is being deposited.

³ Per the Affidavit of Warrant, the real estate was purchased with CBSG funds paid to Heritage, Eagle Six, and LME 2017 Family Trust during the period February 1, 2018 and November 29, 2019.

Steps involved in performing a bank account analysis include (a) analyzing deposits for unusual amounts or frequency, (b) identifying nontaxable deposits such as loans and transfers, commingling of personal and business activities, and cash-backs when a deposit is made, (c) totaling the deposits and (d) reconciling deposits of nontaxable funds and transfers between accounts.

The IRM specifically states that particular attention should be paid to transfers in, out, and between accounts. The nontaxable funds, transfers-in, and return deposits need to be subtracted from the total deposits to get “taxable deposits”. The taxable deposits should then be compared to reported gross income. The analysis should include all accounts, whether designated business or personal. If the analysis results in the identification of excess deposits over the reported gross income, the excess represents potential unreported income.

A potentially material misstatement of taxable income identified through a bank account analysis establishes a reasonable likelihood of additional unreported taxable income justifying the use of a formal indirect method (see discussion below) to determine the actual understatement of taxable income. Formal indirect methods used to determine tax liabilities involve the development of circumstantial proof of income. The IRM further states that examiners are cautioned that the use of a formal indirect method will be determined on a case-by-case basis and the use of a formal indirect method to make the actual determination of a tax liability is not a substitute for reconciling whatever books are maintained by the taxpayer to the tax return.

One such formal indirect method used by the IRS is the Source and Application of Funds Method. This is an analysis of a taxpayer’s cash flows and comparison of all known expenditures with all known receipts for the period. Net increases and decreases in assets and liabilities are taken into account along with nondeductible expenditures and nontaxable receipts. The excess of expenditures over the sum of reported and nontaxable income is the adjustment to income. This method is based on the theory that any excess expense items (“applications”) over income items (“sources”) represents an understatement of taxable income.

Sources of funds are the various ways the taxpayer acquires money during the year. Decreases in assets and increases in liabilities generate funds. Funds also come from taxable and nontaxable sources of income. Specific items of income are denoted separately. Examples of sources of funds include:

- Decreases in cash-on-hand, decreases in bank account balances (including personal and business checking and savings accounts), and decreases in accounts receivable,
- Increases in accounts payable,
- Increases in loan principals and credit card balances,
- Taxable and nontaxable income, and
- Deductions which do not require funds such as depreciation, carryovers and carrybacks, and adjusted basis of assets sold

Application of funds are ways the taxpayer used (or expended) money during the year. Examples of applications of funds include:

- Increases in cash-on-hand, increases in bank account balances (including personal and business checking and savings accounts), business equipment purchases, real estate purchases, and personal assets acquired,
- Purchases, business expenses,
- Decreases in loan principals and credit card balances, and
- Personal living expenses

Determining the beginning amount of cash-on-hand and accumulated funds for the year is important. Since the results of this method are on a cash basis, adjustments must be made for an accrual basis taxpayer.

B. The IRS' Sources of Funds and Expenditures Analysis and Chart

In general, for tax years 2016 to 2018, the IRS examiners compared the taxable income reported on the personal tax returns of LaForte and McElhone⁴ to their expenditures (per bank records with certain liabilities based on tax return reported amounts) and real estate purchases through related entities (per closing statements). Based on this analysis, the IRS investigators concluded that the taxpayers have unreported taxable income in each year examined. For reference, the Affidavit of Warrant included the following table summarizing the total reported source of funds to total expenditures to determine unreported income for the three-year period:

⁴ 2016 and 2017 was Lisa only (married filing separate); 2018 was Lisa and Joseph (married filing jointly)

Filing Status	2016	2017	2018
	Married Filing Separate	Married Filing Separate	Married Filing Jointly
Wages	\$249,231.00	\$240,000.00	\$240,000.00
Dividends	-	\$66,543.00	\$14,500,000.00
Interest	-	\$1,791,380.00	\$4,035,268.00
Income from Related Entities (Schedule E)	\$1,716,284.00	\$2,509,723.00	\$9,606,948.00
\$350K Refi – 2413	\$337,000.00	-	-
Total Reported Source of Funds	\$2,302,515.00	\$4,607,646.00	\$28,382,216.00

Federal Taxes	\$946,333.00	\$1,819,103.00	\$8,585,117.00
RE Taxes - Primary Residence	\$1,530.00	\$53,383.06	\$50,000.00
Real Estate Purchases (unencumbered)	\$2,680,494.00	\$7,548,000.00	\$18,930,000.00
Schedule C Loss	\$10,538.00	-	\$64,241.00
Home Design & Construction	\$213,548.67	\$247,648.14	\$359,588.31
Landscape	\$35,080.09	\$179,663.93	\$504,620.86
American Express	-	\$188,630.00	\$190,000.00
Other Credit Cards	\$28,371.74	\$139,913.55	\$30,958.22
Retail	\$26,300.63	\$66,469.83	\$13,105.01
Medical	-	\$17,950.00	\$7,007.47
Insurance	\$13,784.34	\$53,354.54	\$44,732.12
Utility	\$13,111.69	\$32,724.63	\$27,614.51
Food	-	\$6,530.01	\$4,106.17
Fitness	-	\$8,489.76	\$5,070.00
Armen Chevrolet	\$60,693.48	-	-
Ferrari	-	\$92,379.15	-
Car Maintenance	\$9,154.28	\$15,203.32	\$13,669.92
Pet Care	\$3,939.55	\$7,995.43	\$14,185.10
Boat	-	\$64,673.20	\$174,912.99
Charles Schwab	\$1,000,000.00	\$4,850,000.00	\$500,000.00
Total Expenditures	\$5,042,879.47	\$15,392,111.55	\$29,518,928.68

Unreported Income	\$2,740,364.47	\$10,784,465.55	\$1,136,712.68
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The narrative in the Affidavit of Warrant is limited and does not provide details regarding what, if any, minimum income probes detailed in the IRM were taken to determine that the taxpayers may have unreported income. Based on the brief narrative and chart provided in the Affidavit of Warrant, it appears that the IRS investigators solely utilized the formal indirect “Source and Application of Funds” method, which is a financial status audit technique that is supposed to be used by examiners after a books and records analysis and bank statement analysis are performed evidencing that unreported income may exist.

The “Source and Application of Funds” method was established under the Supreme Court’s approval in *United States v. Johnson*, 319 U.S. 503 (1943). In that case, it was proven that the taxpayer’s personal expenditures exceeded his current income plus his declared accumulated funds. As detailed in the IRM, neither the Code nor regulations define or specifically authorize the use of formal indirect methods. If the examiner has a reasonable indication that unreported income exists, the Service has been granted the authority to use a formal indirect method of reconstructing income to determine whether or not the taxpayer has accurately reported total taxable income received.

Under **Internal Revenue Code (“IRC”) Section 7602(e)**, *Limitation on Examination on Unreported Income*, the code section states that “the Secretary shall not use financial status or economic reality examination techniques to determine the existence of unreported income of any taxpayer unless the Secretary has a reasonable indication that there is a likelihood of such unreported income”. Based on IRC Sec 7602(e), it appears that under present procedures the examiner must first run through the various “minimum income probes” before escalating to the formal indirect methods of financial status audit techniques. There is no indication in the Affidavit of Warrant that the IRS investigators performed minimum income probes such as (1) a reconciliation of the books and records to the tax returns for LaForte, McElhone, and all related entities or (2) a bank statement analysis for LaForte, McElhone and all related entities to conclude that there is a reasonable indication that there is a likelihood of such unreported income.

1. Overall Problems Inherent in the IRS’ Source of Funds and Expenditures Analysis

The IRM states that an IRS examination includes performing an analysis of the taxpayer’s business and personal bank accounts in order to determine unreported income. Therefore, the “Source and Application of Funds” method utilized by the IRS investigators should have encompassed an analysis of the taxpayers’ and all related entities’ financial accounts. This would also include separately analyzing the related entities’ beginning and ending cash account balances, changes in net assets and liabilities, and their sources and applications of funds. Instead, the IRS analysis erroneously included McElhone’s share of the net pass-through income (loss) from these related entities as reported on her personal income tax returns (Schedule E).

Additional distortions resulting from excluding an analysis of the related entities’ sources and applications of funds include:

- Noncash expenses such as depreciation and amortization are not reflected as adjustments in the analysis in order to convert reportable income into sources of funds. The IRS’ chart reflects real estate purchases totaling \$29,158,494 during the tax years 2016 through 2018. Assuming this is the case, noncash adjustments for depreciation and amortization may be substantial and would result in an underreporting of the source of funds available during these years.
- Adjustments for any increases in accounts payable, outstanding loan balances, and credit card balances which would provide sources of funds outside of the income reported on the personal income tax returns of LaForte and McElhone must be considered. No such adjustments are reflected in the IRS’ analysis.
- To the extent that any of the related entities use the accrual method of accounting, adjustments should be reflected to convert McElhone’s share of the net income (loss) to the cash basis. No such adjustments are reflected in the IRS’ analysis.

There is no indication in the IRS analysis that beginning and ending balances of accumulated funds were taken into account for LaForte, McElhone, and related entities. Accumulated funds would include funds that have been taxed in prior years or originate from nontaxable sources, the net of which may result in a source of funds outside of the income reported on LaForte and McElhone's personal income tax returns for the period analyzed.

2. Other Distortions in the IRS' Source of Funds and Expenditures Analysis Related to Sources of Funds

- The IRS chart appears to inadvertently omit \$462,592 of interest income reported on McElhone's 2016 personal income tax return, which should be a source of funds in that year. Based on McElhone's tax return (Schedule B), the majority of this interest income was paid from Heritage Business Solutions, Inc. As such, McElhone may have received loan repayments during the three-year period analyzed, which would provide a nontaxable source of funds not reflected in the reportable income from her tax returns. It is unclear based on the IRS chart if deposits reflected on the bank statements were analyzed and if any loan repayments were identified.
- The IRS chart includes dividend income flowing through indirectly to McElhone (from LME 2017 Trust) as a source of funds. This dividend income was reported as taxable income on her personal tax returns for 2017 and 2018. A separate analysis of these C corporation(s) should be completed to ensure that all nontaxable sources of funds are properly reflected in the analysis.
- The IRS chart appears to inadvertently omit \$129,704 of net capital gains reported on McElhone's 2017 personal income tax return. The actual impact on the analysis may be the gross proceeds (cash received) from the sale of the underlying assets and not just a net capital gain.

3. Other Distortions in the IRS' Source of Funds and Expenditures Analysis Related to Expenditures of Funds

- The IRS did not identify the responsible parties related to the real estate purchases. If these real estate purchases were not made directly by McElhone and LaForte, they should not be included in the disbursements analysis unless the entities' sources of funds are also included in the analysis. For instance, Eagle Six Consultants is a C Corporation, which is a separate taxable entity from McElhone. As such, any income reported by this entity should be separately included in the IRS analysis if they are going to include disbursements related to real estate purchases of this entity.
- The federal income tax expenditures reflected in the IRS chart appear to relate to LaForte and McElhone's federal personal income tax returns and appear to be based on the federal tax liability incurred each year rather than the actual federal tax payments made each year. For instance, McElhone's 2018 IRS account transcript reflects \$8,747,380 in total federal tax payments received by the IRS for tax year 2018; of this amount, \$1,717,749 in tax

payments were received in calendar year 2018 and the remaining \$7,029,631 were received in calendar year 2019. This results in a substantial overreporting of expenditures in 2018.

2. LaForte did not file a personal income tax return for 2016 and 2017

The Affidavit of Warrant (paragraph 234) states “the fact that Joseph LaForte did not file a personal income tax return for 2016 and 2017 and had no reported sources of income, despite operating CBSG, is an indicator of tax fraud”. It is not uncommon for related taxpayers to be owed compensation for services, and due to cash flow and other business reasons, not be paid on a timely basis. Until such payments are made by CBSG, they are unable to deduct such expenses. Since LaForte is a cash basis taxpayer, he is not required to report compensation income until such payments are received from CBSG. This is explicitly stated in IRC Section 267(a)(2)(A), “by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not (unless paid) includible in the gross income of such person...” and in IRC Section 267(a)(2)(B), “...then any deduction allowable under this chapter in respect of such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to whom the payment is made”.

The requirement to file an income tax return is explicitly stated in IRC Sections 6011(a), 6012(a), and corresponding Treasury Regulations. Under these provisions of the Code, any taxpayer who has received more than a statutorily determined amount of gross income during the tax year is required to file a return for the year and pay tax on the income.

If LaForte did not have gross income in excess of the statutory amounts during tax years 2016 and 2017, he did not have a requirement to file a U.S. individual income tax return. This is his right as a taxpayer and is not an indication of tax fraud as the IRS investigators suggest in the Affidavit of Warrant.

3. McElhone filed Married Filing Separate for tax years 2016 and 2017

McElhone filing separately for tax years 2016 and 2017 is a right she has as a taxpayer, regardless if married filing jointly results in a lower tax liability. This right does not indicate tax fraud as the IRS investigators suggest in the Affidavit of Warrant. The reasons why a taxpayer would file separately is discussed in two IRS Publications and further detailed below.

IRS Publication 501, *Dependents, Standard Deduction, and Filing Information*, discusses the option to choose married filing separately as a filing status if a taxpayer is married. The filing status may benefit a taxpayer if they want to be responsible for only their own tax or if it results in less tax than filing a joint return. This filing status is required if the taxpayer and spouse do not agree to file a joint return. Taxpayers who file separate each report their own income and deductions on separate returns (except for those living in community property states).

IRS Publication 4491, *VITA/TCE Training Guide*, further details why married taxpayers would want to file separately if filing jointly generally results in the lowest tax. Married taxpayers

sometimes choose to file separate returns when one spouse does not want to be responsible for the other spouse's tax obligations. Another common reason taxpayers file separately is to avoid an offset of their refund against their spouse's outstanding debts. This includes past due child support, past due student loans, or a tax liability the spouse incurred before they were married.

4. The Allegation that LaForte and McElhone currently owe the IRS approximately \$550,000 related to tax years 2017 and 2018

McElhone's IRS account transcript for tax year 2017 reflects that her personal income tax return was received by the IRS on November 12, 2018 (late filed) and reported \$1,893,183 in total tax liability. The account transcript reflects that \$1,962,078 in tax payments were received by the IRS through the extended tax filing deadline (October 17, 2018). Therefore, it appears that McElhone timely paid 100% of her tax liability by the extended tax deadline and that the current account balance includes late filing penalty, late payment penalty, and related interest (not outstanding taxes).

McElhone's IRS account transcript for tax year 2018 reflects that her tax return was timely filed on September 23, 2019 and reported \$8,585,117 in total tax liability. The account transcript also reflects that \$8,747,380 in tax payments were received by the IRS through the extended tax filing deadline (October 17, 2019). Therefore, it appears that McElhone timely paid 100% of her tax liability by the extended tax deadline and that the current account balance includes late payment penalty and related interest (not outstanding taxes).

A taxpayer has the right to seek abatement of penalties for reasonable cause. We do not know whether McElhone is aware that her 2017 return was filed late or whether she has discussed with her accountants her right to request a penalty abatement if reasonable cause exists.

5. The Claim that CBSG filed false corporate income tax returns for 2015 and 2016

CBSG is a C Corporation, which is a separate legal entity from McElhone with its own tax filing requirements. CBSG is a merchant cash advance company ("MCA"). Accordingly, it makes discounted lump-sum cash advances to merchants based on a fixed amount of the merchants' accounts receivables.

The revenue agent concluded that the deductions of approximately \$10.8 million for cost of goods sold in 2015 and \$20.3 million for accounts receivable purchases in 2016 were erroneous since the accounts receivable were not previously recognized as income. Since CBSG purchased certain accounts receivable, it should not pick up the cost of the accounts receivable as income. Accordingly, the revenue agent's conclusion is inaccurate.

As is typical, the tax preparer prepared the tax adjustments for the 2015 and 2016 income tax returns and the required reconciliation in which the tax preparer would typically analyze net income per books, tax adjustments, and net taxable income.

The taxpayer does not, and has never had, access to the tax methodology used by the outside tax preparer or any adjustments reflected in the outside tax preparer's tax workpapers; we are therefore unable to presently evaluate if these tax adjustments were appropriate. Put differently, we do not know the methodology the tax preparers used to create these deductions. It is common that the methodologies used by accountants in the preparation of tax returns are different than the methodologies used in the preparation of financial statements. In many instances, the differences in methodologies account for the timing of income and deductions reflected on income tax returns versus financial statements.

Paragraph 239 of the Affidavit of Warrant discusses bad debt expenses. For financial and book purposes, provisions for uncollectible amounts are appropriate. It is common and required that tax preparers eliminate provisions for uncollectible accounts and deduct only bad debts that are 100% uncollectible. If the taxpayer's cash collections are reviewed for years subsequent to 2016, an examiner could get an indication if the tax preparer made the appropriate tax adjustments for bad debts.

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