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Internal Revenue Manual Section 4.10.4.6.3 (09-11-2007)

Source and Application of Funds Method

1. The Source and Application of Funds Method 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.
2. The Source and Application of Funds Method and the financial status analysis are both based on an evaluation of the taxpayer's cash flows. The only difference is the use of statistics to estimate unknown personal living expenses. Therefore, when the financial status analysis indicates a reasonable likelihood of unreported income and establishes a reasonable likelihood of unreported income, the Source and Application of Funds Method is an efficient method for determining the actual amount of the understatement of income.