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Internal Revenue Manual Section 4.10.4.6.5 (08-09-2011)

Markup Method

1. The Markup Method produces a reconstruction of income based on the use of percentages or ratios considered typical for the business under examination in order to make the actual determination of tax liability. It consists of an analysis of sales and/or cost of sales and the application of an appropriate percentage of markup to arrive at the taxpayer's gross receipts. By reference to similar businesses, percentage computations determine sales, cost of sales, gross profit, or even net profit. By using some known base and the typical applicable percentage, individual items of income or expenses may be determined. These percentages can be obtained from analysis of Bureau of Labor Statistics data or industry publications. If known, use of the taxpayer's actual markup is required.
2. The Markup Method is a formal indirect method that can overcome the weaknesses of the Bank Deposits and Cash Expenditures Method, Source and Application of Funds Method, and Net Worth Method, which do not effectively reconstruct income when cash is not deposited and the total cash outlays cannot be determined unless volunteered by the taxpayer. If personal enrichment occurs that cannot be identified, the effectiveness of these methods is diminished. For example, the possibility exists that significant personal acquisitions or expenditures are paid with cash and are not evident. The Markup Method is similar to how state sales tax agencies conduct audits. The cost of goods sold is verified and the resulting gross receipts are determined based on actual markup.
3. This method is most effective when applied to businesses whose inventory is regulated or purchases can be readily broken down in groups with the same percentage of markup.
4. An effective initial interview with the taxpayer is the key to determining the pertinent facts specific to the business being examined.