



# Retail Audit Technique Guide

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The taxpayer names and addresses shown in this publication are hypothetical.

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# Table of Contents

- I. Overview.....19
  - A. Background / History.....19
    - A.1. What Retailers Do.....19
    - A.2. Demographics of the Retail Industry.....20
    - A.3. Retail Entities.....20
  - B. Relevant Terms .....20
- II. Chapter 2: Examination Techniques & Job Aids.....23
  - A. Initial Interview .....23
    - A.1. Business Operations .....24
    - A.2. Cash-on-Hand.....24
    - A.3. Personal Expenditures .....24
  - B. Tour of the Business Site.....24
  - C. Information Document Request.....25
  - D. Books and Records .....25
  - E. Third Party Contacts.....26
  - F. Income Issues .....26

<b>F.1. Sources of Income/Receipts for Retailers .....</b>	<b>26</b>
<b>F.2. Target Profit Percentage.....</b>	<b>27</b>
<b>F.3. Vendor Rebates and Allowances .....</b>	<b>27</b>
<b>F.4. Credit and Chargebacks .....</b>	<b>29</b>
<b>F.5. Advance Payments - Gift Certificates and Gift Cards.....</b>	<b>29</b>
<b>F.6. Income from Service-Related Activities .....</b>	<b>30</b>
<b>F.7. Promotional Allowances.....</b>	<b>30</b>
<b>F.8. Prizes and Trips.....</b>	<b>30</b>
<b>F.9. Consignments .....</b>	<b>31</b>
<b>F.10. Sale of Accounts Receivables .....</b>	<b>31</b>
<b>F.11. Lottery .....</b>	<b>31</b>
<b>F.12. Vending Machines.....</b>	<b>31</b>
<b>F.13. Bartering .....</b>	<b>32</b>
<b>F.14. Cash Records .....</b>	<b>32</b>
<b>F.15. Analysis of Gross Receipts.....</b>	<b>33</b>
<b>F.16. In-Depth Examinations of Income (IRM 4.10.4.5) .....</b>	<b>34</b>
<b>F.17. Source and Application of Funds Method (IRM 4.10.4.6.3)</b>	<b>35</b>
<b>F.18. Bank Deposit and Cash Expenditures Method (IRM</b>	

4.10.4.6.4) .....	36
F.19. Markup Method (IRM 4.10.4.6.5).....	37
F.20. Unit and Volume Method (IRM 4.10.4.6.6) .....	37
F.21. Net Worth Method (IRM 4.10.4.6.7) .....	38
G. Cost of Goods Sold .....	38
G.1. Personal Consumption of Inventory .....	38
G.2. Retail Inventory Method (RIM).....	39
G.3. Uniform Capitalization Rules (UNICAP) .....	42
G.4. Last In, First Out (LIFO) .....	42
G.5. Stock Ledger (Inventory) .....	43
G.6. Point of Sale Perpetual Inventory Control System.....	43
G.7. Inventory Purchases .....	43
H. Expenses .....	43
H.1. Franchise Fees .....	44
H.2. Cooperative Advertising.....	45
H.3. Charitable Contributions and Promotions .....	45
H.4. Accruals .....	47
H.5. Covenants Not to Compete .....	47
I. Depreciation and Cost Segregation Studies .....	47

I.1. Depreciation and Cost Segregation Overview.....	47
I.2. Cost Segregation ATG .....	48
I.3. Suspended Acoustical Ceilings .....	49
I.4. Heating, Ventilating and Air Conditioning (HVAC).....	49
J. Other Potential Income Tax Issues .....	49
K. Excise Tax Issues .....	50
L. Employment Tax Issues/Information Returns.....	50
III. Chapter 3: Grocery Stores.....	51
A. Income .....	51
A.1. Food Product Sales - Sales Summary Report .....	52
A.2. Coupon Income .....	52
A.3. SNAP and WIC Income .....	52
A.4. Gift Cards and Certificates .....	53
A.5. Promotional Items .....	53
A.6. Vending Machines.....	54
A.7. Courtesy Account .....	54
A.8. Demonstrators.....	54
B. Cost of Goods/Inventory .....	55

B.1.	Retail Inventory Method (RIM).....	55
B.2.	Last In First Out (LIFO) Method .....	56
B.3.	Vendor Allowances .....	56
B.4.	Cooperative Advertising.....	57
B.5.	Sales-Based (a/k/a scan-based).....	57
B.6.	Slotting (Shelving).....	57
B.7.	Upfront Payments .....	58
C.	Expenses .....	59
C.1.	Advertising or Contribution .....	59
C.2.	Depreciation.....	59
C.3.	Domestic Production Activities Deduction (DPAD) .....	59
C.4.	Donation of Inventoriable Goods.....	60
C.5.	Franchise Fees .....	60
C.6.	Reward Programs (Loyalty Points).....	61
C.7.	Store Remodeling Costs.....	61
C.8.	Other Considerations.....	61
IV.	Chapter 4: Electronic Business & Online Retail.....	62
A.	Introduction .....	62
B.	Identification of E-Business Cases .....	62
C.	Interview Questions .....	66
C.1.	E-Business Online Retail & Services Interview	

Questionnaire .....	66
D. Income .....	68
E. Cost of Goods Sold .....	68
F. Expenses .....	69
F.1. Business Start-Up Costs .....	69
F.2. Research & Experimental Expenditures and Credit.....	69
F.3. Website Development Costs .....	70
G. Other Potential Tax Issues .....	71
H. Glossary.....	71
V. Chapter 5: Retail Liquor Sales .....	72
A. Introduction .....	72
B. Income .....	72
B.1. Other Grocery Sales – Cigarettes, Snacks, Food & Candy Items .....	72
B.2. Check Cashing and Customers’ Payments on Account..	73
C. Cost of Goods Sold .....	73
VI. Chapter 6 : Mobile Food Vendors .....	73
A. Introduction .....	73
B. Income .....	73
C. Cost of Goods Sold .....	74
D. Expenses .....	74
E. Glossary.....	75

<b>VII. Chapter 7: Gasoline Service Stations</b> .....	<b>75</b>
<b>A. Introduction</b> .....	<b>75</b>
<b>B. Initial Interview Questions</b> .....	<b>75</b>
<b>C. Income</b> .....	<b>77</b>
<b>C.1. Incentive Agreements</b> .....	<b>77</b>
<b>C.2. Imaging Reimbursement Payments- Income Issues</b> .....	<b>77</b>
<b>C.3. Oil Company</b> .....	<b>80</b>
<b>C.4. Food, Beverage, Cigarette Wholesalers</b> .....	<b>80</b>
<b>C.5. Parts Suppliers</b> .....	<b>80</b>
<b>C.6. State Certification &amp; Inspection Information</b> .....	<b>81</b>
<b>C.7. State Sales Tax Records</b> .....	<b>81</b>
<b>C.8. Public Records</b> .....	<b>81</b>
<b>C.9. Indirect Methods</b> .....	<b>81</b>
<b>C.10. Other Exam Issues- Omitted Income</b> .....	<b>82</b>
<b>C.11. Surveys</b> .....	<b>82</b>
<b>D. Cost of Goods Sold</b> .....	<b>83</b>
<b>D.1. Shrinkage, Leakage, Theft, and Personal Use</b> .....	<b>83</b>
<b>D.2. Service Station Acquisition Payments</b> .....	<b>84</b>
<b>D.3. Liquidation/Accommodation Agreements, Security</b>	



<b>Agreements, Prepayment/Reserve Account Deposits</b> .....	<b>84</b>
<b>D.4. Rebates</b> .....	<b>84</b>
<b>D.5. Excise and Sales Taxes</b> .....	<b>85</b>
<b>E. Expenses</b> .....	<b>85</b>
<b>E.1. Rent Expense</b> .....	<b>85</b>
<b>E.2. Imaging Reimbursement Payments- Expense Issues</b> ....	<b>85</b>
<b>E.3. Environmental Clean-Up Costs</b> .....	<b>86</b>
<b>E.4. Fixed Asset &amp; Depreciation Issues</b> .....	<b>87</b>
<b>E.5. Bonus Depreciation</b> .....	<b>88</b>
<b>F. Excise Tax Issues</b> .....	<b>88</b>
<b>F.1. Dyed Fuel</b> .....	<b>88</b>
<b>F.2. Blending</b> .....	<b>88</b>
<b>G. Useful Websites</b> .....	<b>89</b>
<b>H. Glossary</b> .....	<b>89</b>
<b>VIII. Chapter 8: Motor Vehicle Dealerships</b> .....	<b>90</b>
<b>A. Introduction</b> .....	<b>90</b>
<b>A.1. Impact of state regulation and state law</b> .....	<b>91</b>
<b>B. Records</b> .....	<b>91</b>

B.1.	Car Jacket .....	91
B.2.	Cash Receipts.....	92
B.3.	Accounting records .....	92
B.4.	Accounts receivable .....	93
B.5.	Examiners insure the reporting of all sales within the proper tax years.....	93
B.6.	Titling Issues and Processes .....	93
C.	Initial Interview .....	94
C.1.	Income Sources: .....	94
C.2.	Sales .....	95
C.3.	Inventory Items.....	96
D.	Overall Accounting Method .....	96
E.	Potential Income Reporting Issues .....	97
E.1.	Trade-ins not recorded .....	97
E.2.	Reporting net sales based on financing obtained, omitting cash received.....	97
E.3.	All purchased vehicles not recorded .....	97
E.4.	Improper allocation of purchase price to a group of	

vehicles .....	97
E.5. “Clunker” cars acquired as part of a package .....	98
E.6. Unusual trade-ins .....	98
E.7. Bartering clubs .....	98
E.8. Alternate sources of information on income .....	98
F. Income from Vehicle Sales .....	98
G. Other Income Sources .....	101
G.1. Auction Fees .....	101
G.2. Credit Life and Disability Insurance Commissions .....	101
G.3. Financing Rebates .....	102
G.4. Extended Warranty/Service Contracts .....	102
G.5. Consignment Sales .....	103
G.6. Dealer Finance Income .....	104
G.7. Sales taxes, registration and licensing fees .....	105
H. Cost of Goods Sold and Purchases/Inventory .....	105
H.1. Repossessed vehicles .....	105
H.2. Purchases from Other Dealers .....	106
I. Expenses .....	106
I.1. Cost of Labor .....	106
I.2. Reconditioning Expenses .....	106
J. Inventory Valuation .....	107

J.1.	Trade-in vehicles .....	107
J.2.	Inventory Records .....	108
J.3.	Inventory Write-downs .....	108
K.	Expense Issues .....	110
K.1.	Commissions and fees .....	110
K.2.	Demonstration Expense .....	111
L.	Related Finance Companies .....	111
L.1.	Diversification of ownership .....	112
L.2.	Validity or Form of RFC .....	113
L.3.	Economic substance of an RFC .....	114
L.4.	Summary .....	114
M.	Non-Prime or Sub-Prime Finance Contracts .....	115
M.1.	How a Non-Prime or Sub-Prime Plan Works .....	115
M.2.	What are the issues? .....	117
M.3.	Sub-Prime Records .....	117
M.4.	Servicing Agreement (referred to as the dealer agreement) .....	118
M.5.	Dealer Manual & Other Literature .....	118
M.6.	Account Statements .....	118
IX.	Chapter 9 : Auto Body/Repair .....	118
A.	Introduction .....	118
B.	Description of Auto Body Repair Process .....	119

B.1. Repair/Replacement.....	119
B.2. Paint Process.....	119
B.3. Other Processes.....	120
B.4. Estimation Process .....	120
C. Some of the differences between body and repair shops: .....	120
C.1. Body Shops: .....	120
C.2. Repair Shops .....	121
D. Initial Interview .....	121
E. Tour of Business.....	123
F. Books and Records .....	123
F.1. General Books and Records .....	124
F.2. Specific Documents .....	124
G. The Mitchell Guides .....	126
G.1. Organization of Records.....	126
H. Income .....	127

H.1.	Introduction .....	127
H.2.	Parts and Materials .....	129
H.3.	Labor .....	130
H.4.	Sublet .....	130
H.5.	Towing.....	130
H.6.	Storage.....	130
H.7.	Vehicle Sales .....	131
I.	Other Income Sources.....	131
I.1.	Rebates and Refunds of Expense.....	131
I.2.	Supplemental Payments:.....	131
I.3.	Other Sources.....	131
J.	Indications of Underreporting.....	131
J.1.	Estimating Sales.....	132
J.2.	Repair Orders .....	133
K.	Other Income Issues.....	133
K.1.	Waived Deductibles .....	133
K.2.	Cash Payments.....	133
L.	Cost of Sales .....	134
L.1.	Introduction .....	134
L.2.	Purchases .....	134
M.	Records to Request and Examine:.....	134

<b>M.1. General Records.....</b>	<b>135</b>
<b>M.2. Purchases Audit Procedures .....</b>	<b>135</b>
<b>M.3. Labor .....</b>	<b>136</b>
<b>M.4. Sheet Metal Labor .....</b>	<b>136</b>
<b>M.5. Frame Labor.....</b>	<b>136</b>
<b>M.6. Paint Labor.....</b>	<b>136</b>
<b>M.7. Minor Mechanical Repairs .....</b>	<b>137</b>
<b>M.8. Labor Audit Procedures .....</b>	<b>137</b>
<b>M.9. Sublet Expenses.....</b>	<b>137</b>
<b>N. Expenses .....</b>	<b>138</b>
<b>N.1. Uniforms.....</b>	<b>138</b>
<b>N.2. Other Investments Account of the 1120 Balance Sheet.</b>	<b>138</b>
<b>N.3. Non-cleared Checks.....</b>	<b>139</b>
<b>O. Other Receivables.....</b>	<b>139</b>
<b>O.1. Automobile Rental.....</b>	<b>139</b>
<b>O.2. Finders or Referral Fees .....</b>	<b>139</b>
<b>O.3. Lien Sale Filings .....</b>	<b>139</b>
<b>O.4. Towing Service Payments .....</b>	<b>140</b>
<b>O.5. Insurance Fraud .....</b>	<b>140</b>
<b>O.6. Smog Certificate Sales .....</b>	<b>140</b>
<b>P. Glossary.....</b>	<b>140</b>

<b>X. Chapter 10: Direct Sellers</b> .....	<b>143</b>
<b>A. Introduction</b> .....	<b>143</b>
<b>B. Types of Direct Selling Companies</b> .....	<b>144</b>
<b>C. Demographics of Direct Sellers</b> .....	<b>144</b>
<b>C.1. NAICS Codes and the Direct Selling Industry</b> .....	<b>145</b>
<b>C.2. Industry Organizations:</b> .....	<b>146</b>
<b>D. Income Issues</b> .....	<b>146</b>
<b>D.1. Gross Receipts</b> .....	<b>146</b>
<b>D.2. Form 1099-MISC</b> .....	<b>147</b>
<b>E. Expense Issues</b> .....	<b>148</b>
<b>E.1. Start-Up Expenses</b> .....	<b>148</b>
<b>E.2. IRC § 195</b> .....	<b>149</b>
<b>E.3. Inventory and Cost of Goods Sold</b> .....	<b>150</b>
<b>E.4. Other Expenses that Direct Sellers May Deduct</b> .....	<b>151</b>
<b>E.5. Automobile Expenses</b> .....	<b>151</b>
<b>E.6. Home Office Deductions</b> .....	<b>152</b>
<b>E.7. Partnership v. Sole Proprietorship</b> .....	<b>152</b>
<b>E.8. Employee v. Independent Contractor</b> .....	<b>153</b>
<b>F. Questions to ask on this issue:</b> .....	<b>155</b>
<b>G. Profit v. Not-For-Profit Issue</b> .....	<b>155</b>
<b>XI. Chapter 11: International Considerations</b> .....	<b>156</b>
<b>A. Introduction</b> .....	<b>156</b>



<b>B. Business Outbound (Multinational Enterprise with a US Parent)</b>	<b>156</b>
B.1. Transfer Pricing Outbound.....	157
B.2. Practice Units for Transfer Pricing Outbound issues:...	157
B.3. Foreign Derived Intangible Income (FDII) .....	158
B.4. Controlled Foreign Corporation (CFC) Income .....	158
B.5. Foreign Tax Credits Business.....	158
B.6. Repatriation .....	159
<b>C. Business Inbound (Multinational Enterprise with a Foreign Parent).....</b>	<b>159</b>
C.1. Jurisdiction to Tax Business .....	159
C.2. Transfer Pricing Inbound: .....	160
C.3. Inbound Financing .....	161
C.4. Base Erosion and Anti-Abuse Tax (BEAT) .....	161
C.5. Withholding Business.....	162
<b>D. Cross-Over and Other Technical Topics (any Multinational Enterprises) .....</b>	<b>162</b>

D.1. Treaties.....	162
D.2. Exchange of Information: .....	163
D.3. Information Gathering.....	163
D.4. Foreign Currency .....	164
D.5. Organization/Restructuring.....	165
D.6. Earnings and Profits .....	165
XII. Chapter 12: Additional Information .....	165
A. Useful Retail Web Sites .....	165
XIII. Chapter 13: Exhibits .....	166
A. Exhibit 1: E-Business/E-Commerce .....	166
A.1. Explanation for E-Business Online Retail & Services Interview Questions .....	166
B. Exhibit 2: Planning & Examination of Construction “Tenant” Allowances for Leases Greater Than 15 Years (March 24, 2003) 175	

## I. Overview

- (1) The purpose of this Audit Technique Guide is to provide guidance on conducting income tax examinations in the retail industry. It incorporates practical procedures and techniques that are unique to the retail industry. These procedures and techniques combined with the examiner's good judgment, skill and experience will allow the examiner to complete examinations within the shortest possible time with the least burden possible to the taxpayer. The use of these techniques does not imply that the object of the examination is to find a deficiency; the objective is to determine whether the reported income and expenses have been accurately reported.
- (2) The facts and circumstances of each taxpayer are unique; therefore, the procedures applied will be slightly different in every examination, and the strategy will remain dynamic. The examiner will use techniques appropriate for each specific case and will apply his or her basic knowledge when working the exam issues.

## A. Background / History

- (1) Retailers purchase items from a supplier or wholesaler for re-sale at a profit. The retailer earns his living by making a profit on the re-sale. A retailer, such as an auto dealership, may offer only one type of product where there is little competition and use a substantial markup. Or a retailer, such as a convenience store, may offer many different products or models, so customers will be certain to find an item to buy in his store and not in a competitor's store. Some retailers, such as grocery stores, earn a small profit on many items and rely on the volume of sales, or turnover, to account for their profits. The retailer will constantly assess whether items for sale are turning over properly and, if necessary, will retire an item or product and introduce new items or products for sale.

### A.1. What Retailers Do

- (1) Retailers purchase a product, mark up its cost, and advertise it for sale. The mark-up process is key to the retailer's business. If the product is marked up too high, consumers will not buy it; but if the mark-up is too low, the retailer will lose profits and the supply may be quickly exhausted. Another key to the retail business is knowing what the customer needs or wants and when, how much the customer is willing to pay for the product, what the competition is charging, and where to find the product at the best possible cost to make a profit.
- (2) Items and products held in the retailer's possession for sale are called inventory. Inventory is money out of the retailer's pocket, so the retailer tries to keep on hand only the amount that is needed. The retailer only makes money when inventory is sold, and business profitability is measured by inventory turnover rates. All decisions made in this process—finding the product to sell,

marking up its cost and placing it for sale—are made with the expectation of earning a greater profit.

## **A.2. Demographics of the Retail Industry**

- (1) Retail is one of the largest industries in the United States<sup>1</sup>. Retail business covers many different areas, including auto dealerships, convenience stores, gift shops, clothing stores, grocery stores, etc.
- (2) There has been enormous growth and innovation in American retailing in this century. Neighborhood markets and drugstores of the early 1900's succumbed to population growth and demographic shifts to become department stores and grocery stores in the 1950's. As cities became crowded, families continued to move, the interstate road system improved, and suburban shopping centers and malls were created. Chains, franchises and catalogs have built many retailers into national brands today. Retail warehouse concepts continue to increase. Technology has enabled product scanning, sophisticated marketing techniques and internet shopping.
- (3) Technology has also played a significant role in acquiring and maintaining inventory. It has allowed a "partnership" between vendors and retailers in quick response replenishment of inventories. Point-of-sale terminals, bar coding, customer credit cards, etc., have led to better, more accurate recordkeeping by retailers.

## **A.3. Retail Entities**

- (1) Small retailers, such as independent convenience stores or strip mall boutiques, are sometimes called "mom and pop" stores because they are family owned and operated. This type of business may be a sole proprietorship. Even if more than one family member works in the store, only one may be the proprietor. Only the proprietor will pay self-employment tax. It is not unusual for "mom and pop" stores to enter into a partnership, or for family members to form a partnership to give each member a share in profits or to grow the business.
- (2) Large retailers, such as well-known "big box" chain stores, typically include many store locations and hundreds of employees. Both small and large retailers might include activities reported as sole proprietors on Form 1040, Schedule C, as partnerships on Form 1065, or as corporations on Form 1120 or Form 1120S.

## **B. Relevant Terms**

- (1) It is recommended that examiners familiarize themselves with the terms unique to the retail industry prior to the initial interview to facilitate the examination.
- (2) Each Retail sub-industry will also have its own unique terminology. See each sub-industry chapter for additional terms and definitions.

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<sup>1</sup> Kalish, Ira (2008). Revisiting retail globalization: A Deloitte Research Global Retail Study.

<b>Industry Term</b>	<b>Definition or Explanation</b>
Additional Markup	An increase above the original selling price. (See “Markup” below.)
Bar Code	A series of vertical or horizontal parallel lines forming a code that is optically read and interpreted by a bar code scanner. Used on envelopes and forms for rapid entry of data and for sorting. Bar coding may be an indication that the inventory is computerized.
Chargebacks	The retailer’s invoice for claims against a vendor resulting from items such as damaged merchandise, cooperative advertising costs, adjustments, and the recovery of transportation charges for improperly routed merchandise. Chargebacks are usually shown on the vendor’s invoices.
Cooperative Advertising	Advertising paid for jointly by the advertiser and its wholesalers or retailers. For example, the landlord of a strip mall may collect payment from each tenant to pay for advertising that will benefit all the tenants.
Cost Complement	The relationship between the cost of merchandise and the retail value of the items handled during an accounting period. It is the dollar value of the inventory at cost, divided by the dollar value of the inventory at retail.
Count and Recount Discount	Also called a “count and recount allowance”, it is a discount (or allowance) a vendor gives to a retailer based on the number of units of a particular product sold during a specified time period. The vendor counts the product in the warehouse or store at the start of the promotion period and recounts the same product at the end of a promotion period to determine the quantity sold, which is used to compute the allowance amount.
Layaway	A method of deferring payments whereby the retailer retains goods until the customer has completed payments for them.
Markdown	A reduction of an originally established selling or previous retail price.
Markup	The difference between cost price of goods and their retail price. The initial margin between the

Industry Term	Definition or Explanation
	selling price and cost. It also is referred to as mark-on or gross margin.
Markup Cancellations	A reduction in the price of an item after it has been subject to an additional markup. Markup cancellation never exceeds the amount of additional markup applied to an item; thus, it does not reduce the selling price below the original selling price.
Markdown Cancellations	The increase in the retail price of an item that has been reduced. An increase in the selling price, following a markdown, which does not raise the new selling price above the original selling price.
Promotional Markdowns	A lowering of the retail price hoping to encourage greater store traffic. Unlike clearance markdowns, promotional markdowns are regarded as an integral part of some retailers' offensive strategy calculated to increase sales. Frequently the promotional markdowns are temporary.
Point of Sale (POS)	Also, called "point of purchase", a point of sale is the time and place where a retail transaction is completed.
Push Money	Bonus money paid by a vendor or a retailer to salespeople for selling specially designated merchandise.
Quick Response (QR) Inventory System	A cooperative effort between retailers and their suppliers aimed at reducing retail inventory while providing a merchandise supply that more closely addresses the actual buying patterns of consumers.
Retail Method of Inventory	An accounting technique for recording all inventory inputs, including sales, purchases, markdowns, and so on, at their retail values. Purchased items are recorded at cost.
Retail Price	The price at which goods originally are offered for sale.
Scan Downs	Money a retailer receives from a vendor for selling a product within a specified time period. The vendor counts the number of items sold through the point of sale system and rewards the retailer for each sale made during the promotion period.
Shrinkage	The gradual loss of inventory over time due to damage, misplacement, or theft.
Specialty Stores	Retail outlets that maintain a large selection in a limited line of merchandise.

<b>Industry Term</b>	<b>Definition or Explanation</b>
Stock Book	A book in which a retailer enters additions to stock (inventory) which represent merchandise received from vendors, and merchandise deductions which represent sales to customers.
Stock Keeping Unit (SKU)	A measure of an item of merchandise for inventory management. In inventory control and identification systems the SKU represents the smallest unit for which sales and stock records are maintained.
Stock Overage	A condition where the actual items on hand, as determined by physical inventory, is greater than the amount indicated in the stock (inventory) records.
Trade Discount	A deduction from the agreed price, usually expressed as a percentage or a series of percentages that is used in commerce to encourage prompt payment of bills. It should not be entered in the books of account, nor should it be a type of earnings.
Workroom	In retailing, a non-selling area devoted to such support services as apparel alterations, etc.
Universal Product Code (UPC)	UPC is a categorization where each item is given a ten-digit number, pre-marked on the package by the producer in the form of a bar code over ten corresponding numbers.
“Z Tapes”	Print-outs from a simple cash register which a key employee or manager can run using the register’s “Z” key. They summarize the entire history of activity on the cash register for a specific period.

## II. Chapter 2: Examination Techniques & Job Aids

### A. Initial Interview

- (1) The initial interview is an important element of any examination and sets the stage for the rest of the examination. The primary purpose of the interview is to secure, by conversation with the taxpayer, sufficient facts which will present the overall financial picture, an understanding of the operations, and an overview of the recordkeeping practices. This is the examiner’s chance to learn exactly how the business works and how cash is handled.
- (2) Information provided during the initial interview can save significant time and effort in unnecessary examination steps. Remember, the examiner is testing the accuracy of the taxpayer’s tax return and the sources of gross income. The

interview is the best opportunity to allow the taxpayer to provide information not shown on the return.

- (3) In addition to the general interview items usually covered, specific questions relating to the retail business should also be included. Some of the items to be developed in the initial interview include business operations, cash-on-hand, and personal expenditures, all of which are discussed in more detail in the next three sections. This list is not all-inclusive and some of the questions may not be pertinent in all examinations. The initial interview should always be tailored to the taxpayer under examination. See IRM 4.10.3.3 for more information on the interview's purpose and the examiner's authority to conduct taxpayer interviews.

### **A.1. Business Operations**

- (1) Many "mom and pop" stores are cash intensive. Understanding how the taxpayer handles and accounts for the money is important.
- (2) Ask the taxpayer how the inventories are valued, and the method used. This is needed for calculations of markup and/or gross profit. Find out who takes the physical inventories and when they are performed. Ask for the workpaper that calculates the inventory value.
- (3) Control procedures in many small businesses are often weak or nonexistent. This may be due to cost factors, the lack of well-trained accounting staff or a lack of concern with this aspect of the business. Smaller businesses generally have a higher level of "control risk," which is the risk that a material misstatement could occur that will not be prevented or detected in a timely manner by the business's internal control structure, policies, or procedures.

### **A.2. Cash-on-Hand**

- (1) It is imperative that cash-on-hand is covered during the interview. The examiner should probe for all funds to which the taxpayer had access, including funds available. Make sure the taxpayer understands that cash includes pocket money plus cash in a safe, safe deposit box, or stored at home.

### **A.3. Personal Expenditures**

- (1) Many retail business owners use some of their inventory for personal purposes. The key here is to verify that the personal-use amount is properly accounted for and deducted from cost of goods sold or purchases.

## **B. Tour of the Business Site**

- (1) The tour of a taxpayer's business site is an important part of the examination process for every type of taxpayer. By touring the taxpayer's facilities and observing business activities, the examiner can get an overview of the business operations and clarify information obtained in the taxpayer interview. Once the examiner understands the business operations, the examiner will be better able to determine whether the taxpayer's books and records accurately reflect actual



operations. For example, the examiner has a liquor store under examination. During a tour of the store, the examiner observes employees selling lottery tickets from behind the counter. Thus, the examiner expects to see lottery ticket sales revenue reported on the store's books. The tour also gives the examiner an opportunity to observe internal controls, which the examiner will test as a part of the examination.

### C. Information Document Request

- (1) Listed below are some documents examiners may want to consider when preparing an IDR for a retail case. Not all of these items should be requested in every case, but examiners should use this information as a guide and request the items that are appropriate and relevant for their specific case.
  - All paid invoices for the year under examination, separated by vendor
  - A listing of all purchases paid in cash
  - Sales, Cash receipts, Purchase, and General journals
  - General Ledger
  - Adjusting journal entries
  - All daily cash register tapes (including the summary tapes called 'Z' tapes)
  - All bank statements for the year under examination, including deposit slips and checks written
  - Workpapers supporting the inventory computations
  - List of vendors who offer vendor allowances such as rebates
  - Documentation of any nontaxable income

### D. Books and Records

- (1) Due to the diversity of the industry and the types of business organizations, the examiner may find a variety of books and records during the examination. Some taxpayers will have technologically sophisticated accounting systems that allow for very detailed records of sales and purchases. They may describe the quantities purchased and the price paid each time. Other taxpayers will not have a structured purchase journal but may only have invoices and cancelled checks.
- (2) **Z Tapes** - Most simple cash registers contain a "Z" key which can only be operated by the manager, owner or a key employee. The Z key totals the entire history of activity on the cash register for a specific period, providing a summary total for sales taxable sales, non-sales taxable sales, credit card sales, credit card tips, cash sales, lottery sales, coupons and discounts, etc. Each day's Z tape is used to record the daily sales in the sales journal. The retailer must retain these tapes and make them available for the examination. Without the Z tapes the examiner cannot know if all transactions are recorded. The examiner

will conduct an audit test on the Z tapes, matching them to the entries in the sales journal and determining what sales are captured on the tapes.

- (3) **Point of Sale (POS) System** - This is a computerized accounting system that records sales along with related items, such as employees' time and tips received, reductions to inventory, and calculations of profit on each sale. These systems can produce financial statements, periodic statements of profit and loss, profits per item, payroll checks, etc. When the examiner suspects that the computer program used by the taxpayer is not recording all sales properly, a referral should be made for an IRS computer audit specialist (CAS) who will run an audit test of the computer program.
- (4) **Inventory Reports** - If a retailer maintains inventory, it should have some type of inventory reports. The retailer will usually take a physical inventory annually to determine if there is old merchandise that should be discounted for a quick sale.
- (5) **Cash Pay Outs** - As discussed above, accounting for cash is a primary focus for the examiner. Some taxpayers keep daily envelopes with the cash paid out and the cash taken in recorded on the envelope. Others maintain a separate file for receipts paid in cash.

## E. Third Party Contacts

- (1) Occasionally taxpayers are unable or unwilling to provide the information (books & records, interview question responses, etc.) necessary for the examiner to conduct a thorough exam. In these instances, the examiner may be able to contact a third party for the necessary information. See Internal Revenue Manual (IRM) 25.27.1 for details on the Third-Party Contact Program.

## F. Income Issues

- (1) The examination of income is a mandatory audit issue and the examiner must conduct minimum income probes during every examination. See IRM 4.10.4.3.3 (for individual business returns) and IRM 4.10.4.3.4 (for corporate and other business returns) for details.

### F.1. Sources of Income/Receipts for Retailers

- (1) Gross income includes consideration received for merchandise sold for cash or credit and for services that are incidental to the sale of merchandise. Retailers generally record income at the time of sale when payment is made, delivery has occurred, and the sales price is fixed. In some situations (e.g. e-commerce and catalog sales), income may be recorded at the time of delivery (i.e. customer receipt). Retailers generally include shipping and handling revenue as items of gross income. However, sales tax collected from customers is generally excluded from gross income and is recorded only on the balance sheet (a debit to Cash and a credit to Sales Tax Payable when received from the customer; and a debit to Sales Tax Payable and a credit to Cash when paid to the government).

## **F.2. Target Profit Percentage**

- (1) Retail buyers negotiate the terms of purchase of merchandise. The buyer is responsible for assuring that the merchandise to be acquired can be sold at a retail price that will generate the targeted profit percentage. Some retailers desire a no-frills purchase for the lowest possible price. In most transactions, however, there are numerous incentive allowances or rebates offered or demanded as part of the overall negotiated price. These allowances may initially result in a higher purchase price for the merchandise ordered, but the retailer expects that this higher initial cost will be more than offset by the allowances. The retailer will enter details of the negotiated agreement into the product data records or will keep a hard copy. It is in the retailer's best interest to monitor its progress in earning incentive allowances and rebates to ensure that it earns all potential recoveries.

## **F.3. Vendor Rebates and Allowances**

- (1) Many vendors offer a rebate or allowance to the retailer when they purchase certain items or quantities. For example, a soft drink vendor may allow a discount on all diet soda purchased if the retailer also purchases 5 cases of a new product, Soda Light. Many times, the vendor allowance will be a reduction of total purchases and will appear on the purchase invoice. Then, the retailer will make payment only for the net purchase amount and will not recognize the vendor allowance as income.
- (2) Some vendors, such as cigarette sellers, allow the retailer to purchase product at discount or warehouse stores. The vendor then issues the retailer a rebate check, resulting in a purchase at less than the retail amount. There is no purchase invoice from the vendor in this transaction, since the purchase was made at another retail store. This type of rebate should appear as an income item.
- (3) The examiner should have the taxpayer explain the various types of allowances and rebates they negotiate and how they account for these allowances for book and for tax purposes. The examiner must determine what accounts the taxpayer uses to record its allowances and rebates, how the accounts are maintained, and who maintains them; then the examiner must review the accounting entries. In addition, the examiner will determine if amounts are recorded when earned or when paid, determine the magnitude of the rebates, determine how many vendors are involved, and secure a list of vendors that offer rebates to the taxpayer.
- (4) The examiner may consider interviewing buyers or other appropriate personnel who have firsthand knowledge of vendor allowances and rebates (in compliance with third party contact provisions) and requesting selected vendor contracts or agreements as well as computation work papers. If appropriate, the examiner will consider a review of any significant allowances reported in the first months of the year to determine if, as of year-end, these amounts were properly accrued or improperly deferred. The examiner will review vendor

accounts to determine if the entries correspond to the source documents secured.

(5) Some of the more common vendor allowances and rebates are listed below. For a more detailed discussion of vendor allowances, see the Vendor Allowances Job Aid in the Inventory & IRC 263A book in the Virtual Library.

- Volume Discount - With this type of discount, the retailer earns money when the quantity of items or dollars of purchases relating either to specific products or all products exceeds certain levels. For example, the retailer may earn a recovery equal to one percent of total purchases when the total purchases reach 103 percent of last year's total. Manufacturers often offer the retailer volume discounts in the form of prizes and awards.
- Advertising Allowance - This allowance also is based upon volume of purchases. The retailer generally does not have to submit advertising documentation or verification to receive this type of allowance, unlike cooperative advertising. It is not unusual for retailers to negotiate agreements to receive both advertising allowances and cooperative advertising.
- Cooperative Advertising - In cooperative advertising, a portion of the retailer's advertising costs is borne by certain vendors in accordance with cooperative advertising offers of the vendors. It is industry practice for many large vendors to open their cooperative advertising allowance program to most customers. Allowances from some vendors will be limited to a percentage of purchases, which will vary from vendor to vendor, and will sometimes fluctuate according to the volume of purchases.
- Defective Merchandise - This allowance, usually based on a percentage of purchases, covers the cost of defective merchandise or the handling costs related to it.
- Markdown Participation - Vendors agree to reimburse all or a portion of product markdowns taken on a specific product to instill confidence in the buyer that the product will perform as predicted.
- Shelving or Fixture Allowance - The vendor may either provide product shelving or money for the purchase of product shelving. For example, a retailer may receive a display case from a vendor on condition that it is strategically placed and used to market the designated product for a certain period. In either situation, the retailer treats the money, or the value of the shelving received as other income. If the shelving remains the property of the vendor, there is no allowance involved.
- Slotting Allowance - The vendor desires to have its product displayed in a prominent location, which will help generate sales. The vendor may offer, or the retailer may demand, payment to secure an agreement for specific space.

- **New Store Allowance** - The vendor may offer free or reduced-price merchandise or non-inventory prize merchandise which would be raffled to store customers in conjunction with the opening of a new store.
- **Free Merchandise** - The vendor may have a promotion for a specific time during which the retailer may receive free merchandise after purchasing similar merchandise. As an example, for every 100 golf bags purchased, the vendor will provide an additional 10 bags at no extra cost.
- **Handling Allowance** - The retailer may receive funds from vendors to offset certain costs of handling merchandise, such as the cost of removing items from boxes and placing each item on a shelf.
- **Holiday Allowance** - Some vendors allow retailers to retain holiday merchandise but reduce the following month's billings by the remaining holiday inventory. The holiday inventory is then re-billed the following holiday season. This is done for all holidays, such as Christmas, Easter, Mother's Day and Halloween.

#### **F.4. Credit and Chargebacks**

- (1) Purchase credits or chargebacks are claims against a vendor resulting from items such as damaged merchandise, cooperative advertising costs, adjustments, and the recovery of transportation charges for improperly routed merchandise. Sometimes the vendor determines the amount of an allowance or rebate and issues a purchase credit or chargeback to the retailer. In other instances, the vendor sends a notice to the retailer, after the earning period has expired, which reflects the final computation of the rebate amount, possibly accompanied by payment. When amounts are in dispute, the retailer will in most instances shift the burden of proof to the vendor, simply by withholding payment for merchandise purchases.

#### **F.5. Advance Payments - Gift Certificates and Gift Cards**

- (1) For financial reporting purposes, advance customer payments for goods and services are generally deferred beyond the date of payment. Common prepaid income items in retailing include gift card sales, layaway sales, club memberships, and extended service plans. Prepaid income items are typically credited to a current liability account at the time of cash receipt. Income is recognized at some later date, which may be a different tax year.
- (2) In general, gift card income must be recognized when received under the "full inclusion method. Treas. Reg. §1.451-5 was subsequently removed in July of 2019, when the IRS and Treasury released final regulations under the Tax Cuts and Jobs Act (TCJA). New IRC §§ 451(b) and (c) override the Treas. Reg. § 1.451-5 deferral method. For more information on advance payments from gift cards, see the Timing of Income- Specific Issues book on the Methods of Accounting and Timing shelf in the Servicewide Virtual Library.

## **F.6. Income from Service-Related Activities**

- (1) Many retail establishments have departments designed to support sales; these departments are not a major source of income or expense to the retailer but are incidental to the primary business of the store. For example, a retail craft store may have a separate department that provides matting and framing services. Or a florist will arrange bouquets for customers or will sell small gifts. Often these incidental services will be performed in-house.
- (2) Take a tour of the retailer's facility or telephone the sales location and ask what services are available to determine whether the taxpayer offers ancillary services. Analyze general ledger accounts to determine whether income from service departments exists, and, if so, how the retailer books related income and expenses. Often, income and expense may be netted into the same account, and a growing credit balance in a balance sheet account may signal an improper deferral of income.
- (3) Another area to consider in relation to service departments is how the taxpayer treats them in its cost of sales calculation. Many taxpayers will treat them as a cost of sales for book purposes and as a period cost for tax. The Service contends that both income and expense should be treated as part of the cost of sales calculation. (Prior to the removal of IRC § 453A deferred gross profit in 1986, the difference in treatment was an area of some concern, as the amount of deferred income was directly affected by the gross profit percentage. The issue was addressed in *Marcour, Inc. v. Commissioner*, 89 TC 181 (1987), non acq., 1990-2 C.B. 1., where it was decided that service department cost was not an item which should be included in cost of sales. However, the Commissioner has non-acquiesced to this decision.)

## **F.7. Promotional Allowances**

- (1) Sometimes the taxpayer receives promotional allowances before it has met all the criteria for earning them. The examiner should apply the all-events test under IRC § 451 before permitting a deferral of income. Only the unearned portion qualifies for deferral. Accounts with titles such as Accounts Receivable Credit Balances or Unearned Promotional Allowances, or which refer to rebates, promotional advertising, bill backs, allowances, discounts, or similar wording may include improperly deferred income.

## **F.8. Prizes and Trips**

- (1) Retailer owners may receive prizes, trips, and/or free promotional merchandise from vendors or manufacturers. Since these types of items fall outside the normal income stream, they are easily omitted from income. If such transactions are booked at all, they may be run through cost of sales. Interview the retailer, manager, officer or shareholders regarding trips taken, prizes won, meetings attended, etc.

## **F.9. Consignments**

- (1) Retailers may receive and/or send out merchandise on consignment. Consignments of merchandise to others are not sales since the title of merchandise remains with the consignor (Treas. Reg. §1.471-1). Therefore, if goods are shipped on consignment, the consignor has no profit or loss until the consignee sells the merchandise. Merchandise that has been shipped out on consignment is included in the consignor's inventory until it is sold.
- (2) Merchandise received by the retailer on consignment is not included in the retailer's inventory. The profit or commission on merchandise consigned to the retailer is included in the retailer's income when the merchandise is sold. In summary, include in inventory goods out on consignment; do not include in inventory goods received on consignment.
- (3) Question the retailer owner regarding items out on consignment at another location. Owners may display merchandise at malls, flea markets, and antique shows. Income from these sales should be included in gross receipts.

## **F.10. Sale of Accounts Receivables**

- (1) Many issues can arise from the sale of a business. Among them is how to handle the outstanding accounts receivable. Secure and inspect the sales contract and consider the various issues that may be present. Generally, for a corporation, the sale of accounts receivable should be considered income to a corporation and a dividend to the shareholders. See IRC §§ 301(c) and 311(b).

## **F.11. Lottery**

- (1) Most state lotteries provide monthly activity reports to account for a retailer's lottery sales, commissions and bonuses. Generally, retailers receive a commission from the state lottery that is only a small percentage of their lottery ticket sales. They may also receive a bonus when a winning ticket is sold, typically a small percentage of the jackpot. When the retailer makes a lottery sale, it collects the funds, and the state withdraws the funds periodically from the retailer's bank account. In many cases the state requires retailers to maintain a separate bank account for these funds.
- (2) Lottery rules vary from state to state, so the examiner should ask the retailer how much it earns from lottery sales, how it remits funds to the state lottery commission, and how it records the revenue on its books. The examiner can verify income using Form 1099 and monthly activity reports, both issued by the state lottery commission.

## **F.12. Vending Machines**

- (1) When a retailer allows vending machines in the business, the examiner must determine how the retailer accounts for the income received. In some cases, the retailer rents the space to the vendor and receives a monthly payment, but most likely the retailer has a contract that pays a percentage of the receipts of the machines. If the retailer owns the machines, inspect the records for the

periodic influx of coin currency. This could be a deposit of coins from the vending machines.

### **F.13. Bartering**

- (1) The examiner is required to determine if bartering exists and if so, to determine if the value of bartered goods is properly recorded in income. A barter exchange is a third-party organization that coordinates barter transactions between members and operates in a similar manner as a commercial bank. A business owner completes a membership application, pays a fee and deposits funds in the exchange, which opens a barter account in the business's name. This account provides barter script which may be used, like a check, at other participating barter businesses. The bartering organization publishes periodic catalogs from which participants may also purchase items.
- (2) When another participant purchases goods from the retailer by barter, the value of the goods is added to the retailer's barter account. Bartering in this manner is helpful to a retailer because they can trade away unused inventory or excess resources and acquire needed business goods or personal items without affecting the cash flow. Because the business is listed in a barter catalog, this is also an advertising bonus. Retailers can also barter on a less formal basis by simply trading work with friendly business associates. In any case, determine the extent of the bartering and ensure the value of goods provided is included in gross receipts.

### **F.14. Cash Records**

- (1) Retailers use different methods to collect and account for cash. In some stores, only the owner collects cash from customers, and it is kept in a drawer or box. In larger stores, key employees collect and account for cash. In more sophisticated systems a point of sale (POS) cash register records sales and decreases in inventory at the same time.
- (2) It is important to find out who collects the cash, where it is kept, and who reconciles it to sales at the end of the day or shift. When cash is used to pay vendors or make purchases, determine who is authorized to make the payment and what the procedure is. It is also important to find out who takes the cash to the bank and into what accounts it is deposited.
- (3) A thorough understanding of how the taxpayer handles cash is particularly important in the retail industry. Even with weak internal controls, a taxpayer may be properly reporting income, but the examiner should still gather detailed information about how the business is conducted, document cash inflows and outflows, and thoroughly interview the owner regarding cash receipts and expenditures.
- (4) The records created (hard copy or digital) by the accounting system will also provide a valuable source of information in the examination of the retail businesses. Ask the retailer for a complete explanation of the accounting



system, both in theory and in practice, prior to beginning the examination of the books and records.

- (5) If the retailer has a computerized cash register system and cannot provide the requested financial records, the examiner can contact the cash register manufacturer for instructions on obtaining the reports needed. Most programs in existence today can run the essential reports necessary to properly determine the correct tax liability and to comply with tip reporting.
- (6) During the initial interview, ask the retailer what percentage of sales is attributed to cash compared to credit or check payments. Analyze the bank deposits, verify the cash sales percentage, and question any discrepancies. During the tour of the business, be alert to the types of payments made and how they are handled and recorded.
- (7) Despite the modern record keeping systems available, many small retailers choose to report gross receipts based on amounts deposited to the business bank account. When cash is not deposited in the bank, or when checks are cashed or deposited into an account other than the business account, this method of reporting income is not accurate.
- (8) As a result, the examiner must check for unreported receipts. A retail business may receive some personal checks as payment for services. If the customers know the owner, whether the retail business is a corporation or sole proprietorship, some of the checks may be made to the owner personally. It would be easy for the owner to cash these checks or divert them into personal bank accounts. Therefore, it is imperative that each examination includes alternative methods to verify gross receipts.

## **F.15. Analysis of Gross Receipts**

- (2) Before reviewing records for specific sources of receipts, do the following:
  - Analyze the duplicate deposit slips. If the business is cash intensive there should be frequent and significant cash deposits. Calculate the percentage of cash receipts compared to check and/or credit card payments.
  - Analyze the cash register records. The retailer typically enters a month's worth of Z-tapes into the accounting records or into a spreadsheet or writes them by hand on a monthly sales sheet. Total the monthly sheets to compare recorded sales with gross receipts on the tax return. Use the monthly sheet for a sample month and verify the daily tape amounts were entered correctly.
  - Analyze business cash pay outs. Verify the income was reported before it was paid out for business expenses.
  - Review sales tax returns. The gross sales reported to a state sales tax agency will generally match the gross receipts reported on the income tax

return. If not, reconcile any differences. It is also important to determine whether sales taxes were included in the total sales dollars. The retailer should not include sales taxes in gross receipts and should not deduct state and local sales taxes collected and paid over to the state or local government. Be alert for double deductions in sales taxes paid for purchased items, such as taxes included in cost of goods sold and as a separate expense item.

## **F.16. In-Depth Examinations of Income (IRM 4.10.4.5)**

- (1) As discussed earlier in this Income section, the examiner must conduct minimum income probes when examining any tax return. If the examiner can reconcile a taxpayer's income using minimum income probes, an in-depth examination is not necessary. However, if the examiner cannot reconcile the taxpayer's income using minimum income probes, a more in-depth examination of income may be warranted. The examiner will typically conduct an in-depth examination of income using either the specific items method or a formal indirect method.
- (2) In certain cases, income may be reconstructed using Bureau of Labor Statistics (BLS) data or comparable statistics from a reliable source. This statistical data is not a substitute for taxpayer books and records and should only be used in computing income when books and records are incomplete or unavailable. Statistical data can be used as the sole source of information used to compute taxable income only when no other information is available. See IRM 4.10.4.6.1.3.1 for an explanation of when to use statistical data and the various court cases supporting its use.
- (3) **Specific Items Method:** The specific items method is preferable to an indirect method as it is based upon direct evidence of income. For example, a retailer may receive rebates from a supplier. A copy of the supplier's invoices and cancelled checks establishes the amount of income from these rebates. The specific items method relies on evidence gathered from source documents, rather than estimates. If the examiner cannot obtain income records from the retailer, use information reported to the IRS and/or follow third party contact procedures to obtain information from third parties. See IRM 25.27.1, Third-Party Contact Program for important guidance on third party contact procedures.
- (4) **Formal Indirect Methods:** When the retailer's income records are not available or are inadequate, consider using one or more of the following indirect methods for examining income:
  - Source and Application of Funds Method
  - Bank Deposits and Cash Expenditures Method

- Markup Method
  - Unit and Volume Method
  - Net Worth Method
- (5) The following is a synopsis of the above-referenced indirect methods. Review the appropriate IRM sections for the proper application of these methods. If any of these methods rely on estimates, use other methods for corroboration to establish a strong position.

### **F.17. Source and Application of Funds Method (IRM 4.10.4.6.3)**

- (1) This method is an analysis of a taxpayer's cash flows and comparison of all known expenditures with all known receipts for the period. Consider net increases and decreases in assets and liabilities along with nondeductible expenditures and nontaxable receipts. The excess of expenditures over the sum of reported and nontaxable income indicates an understatement of taxable income.
- (2) The Source and Application of Funds Method is recommended when:
- A review of the taxpayer's return indicates that deductions and other expenditures appear out of proportion to the income reported.
  - The taxpayer's cash does not all flow from a bank account which can be analyzed to trace its source and subsequent disposition.
  - The taxpayer often uses cash receipts to pay business expenses.
- (3) When using the source and application of funds method, remember the following:
- Money the taxpayer used to make cash purchases originated from sales; however, if it was received as cash, the taxpayer may not have deposited it into a bank account. If it was never deposited into a bank account, it must be added back to the bank account analysis.
  - Sales tax collected from customers for cash sales is not a source of income.
  - Cash collected from vending machines is cash that needs to be included in gross receipts. If significant coin and currency deposits are not on the deposit slips, the examiner may need to compute the amount of vending machine income and add it to the bank account analysis.
  - Payments from credit card companies for credit card sales include deposits of employee tips, plus sales taxes, plus the sale. Only the portion representing income from the sale is taxable.

- Loans from shareholders are a non-taxable source of cash. Proof of payment is necessary to establish facts.
  - Transfers between bank accounts are non-taxable.
- (4) See the IRM for additional information on this indirect method, including references to the supporting case law.

#### **F.18. Bank Deposit and Cash Expenditures Method (IRM 4.10.4.6.4)**

- (1) The Bank Account Analysis method assumes that the business owner deposits all income in a bank account. In a cash-intensive business, this may not be the case, so the Bank Account Analysis should generally be supplemented with another indirect method when auditing a cash-intensive business. When the bank account analysis indicates a reasonable likelihood of unreported income, the examination of income may be expanded to include the use of the formal Bank Deposits and Cash Expenditures Method to determine the actual understatement of taxable income. Unlike the Bank Account Analysis, the Bank Deposits and Cash Expenditures Method is an in-depth analysis of all individual bank account transactions. In addition, the Bank Deposits and Cash Expenditures Method accounts for cash expenditures and actual personal living expenses, whereas the Bank Account Analysis does not.
- (2) The Bank Deposits and Cash Expenditures Method computes income by showing what happened to a taxpayer's funds. It is based on the theory that if a taxpayer receives money, only two things can happen: it can either be deposited or it can be spent. This method is based on the assumptions that 1) proof of deposits into bank accounts, after certain adjustments have been made for nontaxable receipts, constitutes evidence of taxable receipts, and 2) outlays, as disclosed on the return, were made. These outlays could only have been paid for by credit card, check, or cash. If outlays were paid by cash, then the source of that cash must be from a taxable source unless otherwise accounted for. It is the burden of the taxpayer to demonstrate a nontaxable source for this cash.
- (3) If the Bank Deposits and Cash Expenditures Method indicates an understatement of taxable income, it may be due to either underreporting of gross receipts or overstating expenses, or a combination of both.
- (4) To use the Bank Deposits and Cash Expenditures Method in determining income, the examiner must show that:
- The taxpayer was engaged in a business or income-producing activity,
  - The taxpayer made periodic deposits of funds into a bank account or accounts,

- The examiner adequately investigated deposits to negate or eliminate the likelihood that the deposits arose from nontaxable sources of income, and
  - Unidentified bank deposits have the inherent appearance of income; i.e., the size of the deposits, odd or even amounts, source of checks deposited, dates of deposits, etc.
- (5) See the IRM for additional information on this indirect method, including references to the supporting case law.

### **F.19. Markup Method (IRM 4.10.4.6.5)**

- (1) This method produces a reconstruction of income based on the use of percentages or ratios considered typical for the type of retail business under exam. The examiner determines the industry markup for a retailer and applies that markup percentage to the verified cost of goods sold of the retailer under examination.
- (2) Alternately, the examiner can use the retailer's own markup percentages, if possible. The examiner can perform a "shelf test" where current sales prices of in-stock items are compared to their cost to determine the markup percentage. This test is effective if there are only a few types of purchases or only a few suppliers of goods, such as for a gasoline retailer.
- (3) The Markup Method works well for a cash-intensive business or one that does not use bank accounts to deposit receipts, or for a taxpayer where total expenditures (such as personal expenses) cannot be determined. This method is also recommended when inventories are present, but records are unreliable. See the IRM for additional information on this indirect method, including references to the supporting case law.

### **F.20. Unit and Volume Method (IRM 4.10.4.6.6)**

- (1) In many instances, the examiner may be able to compute gross receipts by applying a sales price to the volume of business done by the taxpayer. The examiner may be able to determine the number of units or volume of business from the taxpayer's cost of goods sold or expense accounts. Alternatively, the examiner may need to contact third party sources to determine the number of units or volume of business. This method for computing gross receipts has been effectively applied in carry out pizza businesses, coin operated laundromats, and mortuaries.
- (2) The Unit and Volume Method is recommended for making the actual determination of tax liability when:
- The examiner can determine the number of units handled by the taxpayer and the price charged per unit, and

- The business has only a few types of products which are sold or there is little variation in the types of services performed, and the prices charged for merchandise or services are relatively the same throughout the tax period.
- (3) See the IRM for additional information on this indirect method, including references to the supporting case law.

## **F.21. Net Worth Method (IRM 4.10.4.6.7)**

- (1) This method measures the difference between a taxpayer's net worth (total assets less total liabilities) at the beginning and at the end of the year. An overall increase in net worth represents taxable income. This method works when there is an entire business element missing, such as a retailer that does not report sales from an internet business, or a taxpayer who has additional income from an illegal source.
- (2) The net worth method can also be used to corroborate other methods of proof or to test the accuracy of reported taxable income. See the IRM for additional information on this indirect method, including references to the supporting case law.

## **G. Cost of Goods Sold**

- (1) Cost of goods sold is one of the largest expense items on the return. The two major components of cost of goods sold are inventory and purchases. Inventories are usually the most significant asset a retail business owns. Thus, an adjustment to cost of goods sold may be quite significant.
- (2) Review the accounting method for recording all inventory inputs, including sales, purchases, markdowns, and so on, at their retail values. Ensure that purchased items are recorded at cost.
- (3) Under Rev. Proc. 2001-10, qualifying taxpayers with average annual gross receipts of \$1,000,000 or less are not required to account for inventories. However, these qualifying taxpayers are required to treat what would have been treated as inventory as a "material or supply that is not incidental" under Treas. Reg. § 1.162-3. As a result, the deduction is deferred until the material or supply is consumed or sold.

### **G.1. Personal Consumption of Inventory**

- (1) Since retail store owners are in a position of control, it is imperative that the examiner interview the owner regarding the practice of paying for the inventory consumed personally. An owner "buys" inventory from their own store, as they

would be able to consume the kinds of inventory, they desire at a cost less than retail.

- (2) There are several ways owners account for the inventory they personally consume, including the following:
  - Paying for their own inventory by writing personal checks,
  - Accounting for their personal use by making adjusting entries in their books and records,
  - Treating the amounts as "loans" to themselves from the business,
  - Providing "fringe benefits" to the owners,
  - Considering the personal use as additional wages at the end of the year, or
  - Not accounting for their personal use at all.
- (3) If the retailer indicates the owner paid for the inventory by personal check, verify checks from the owner's personal bank account. If the retailer makes adjusting entries, review the accounting books and records to determine whether the entries were properly made. If the owner treated the amounts as loans, verify that the retailer is accruing interest on the personal consumption account. Also verify the payment plan used by related parties for payment of their personal retailer consumption.
- (4) If the amounts are treated as fringe benefits, verify they are added to the owner's wages at the end of the year. In determining the amount of inventory which is "accounted for" by any method, the examiner should keep in mind there may be employment tax considerations which may need to be addressed. This is especially true in situations where the retail store operates as a corporation.
- (5) The arrangement by which the retailer owners treat the "purchase" of their own inventory may vary in scope.

## **G.2. Retail Inventory Method (RIM)**

- (1) See the Special Inventory Valuation Methods chapter of the Inventory General book on the Inventory and 263A shelf within the Corporate/Business Issues & Credits Knowledge Base in the Servicewide Virtual Library.
- (2) Treas. Reg. § 1.471-8 authorizes retail merchants to use the retail inventory method (RIM) to value their inventory; grocery store operations, for example, primarily use the RIM. RIM uses a formula to convert the retail selling price of ending inventory to an approximation of cost or an approximation of lower of cost or market value (LCM). The formula used for the RIM starts with the retail

value of ending inventory, which is then multiplied by a cost complement to arrive at its approximate cost. Generally, the cost complement is determined by dividing total of opening inventory and purchases at cost by the total of opening inventory and purchases at retail value. Adjust the retail value of opening inventory and purchases (the denominator) for all permanent—not temporary—markups, markdowns, and cancellations.

**Example –** Using RIM to approximate the cost of ending inventory:

	<u>Cost</u>	<u>Retail</u>
Beginning inventory	\$15,810	\$27,000
Net purchases for year	75,190	110,000
Additional markups		5,000
Markup cancellations		(2,000)
Markdowns		(10,875)
Markdowns cancellations		875
Merchandise available for sale	<u>91,000</u>	<u>130,000</u>
Less: Net sales		<u>(90,000)</u>
Ending inventory, at retail		<u>40,000</u>

First, compute the cost complement as follows:

$$\begin{array}{r}
 \text{(Cost of opening inventory + Cost of purchases)} \\
 \hline
 \text{(Retail value of opening inventory + Retail value of purchases) +} \\
 \text{(Markups \& Markdown Cancellations) - (Markdowns \& Markup Cancellations)} \\
 \\
 (\$15,810 + 75,190) \\
 \hline
 (\$27,000 + 110,000) + (5,000 + 875) - (10,875 + 2,000) \\
 \\
 \frac{91,000}{130,000} = 70 \%
 \end{array}$$

Then, multiply the retail value of the ending inventory by the cost complement to arrive at the approximate cost of ending inventory, as follows:

$$\begin{array}{l}
 \text{Approximate cost of ending inventory} = \\
 \text{Retail value of ending inventory} \times \text{Cost complement}
 \end{array}$$

$$40,000 \times 70\%$$



**Approximate cost of ending inventory = \$28,000**

- (3) If the retailer maintains more than one department or deals in multiple classes of goods carrying different percentages of gross profits, the cost complement should be computed separately for each department or each class of goods.
- (4) Arbitrary markdowns for depreciation and obsolescence of the goods will be recognized only if the goods are offered to the customers at the prices so reduced.
- (5) If the retailer wants to value its ending inventory at the lower of cost or market (LCM), rather than cost, the denominator of the cost complement formula is adjusted for mark-ups only. See Treas. Reg. § 1.471-8(b)(3) for other special rules and adjustments made in valuing inventory at LCM using the RIM.
- (6) Because RIM is an averaging method, it has historically been more convenient for most types of merchandise, especially as volume increases. Some advantages & uses of RIM are as follows:
  - Verify the reasonableness of the cost of inventories at the end of the tax year. By using a different set of data from that used in pricing inventories, the examiner can establish that the valuation of inventories is reasonable.
  - Estimate the cost of inventories for the tax year without taking physical inventories.
  - Value inventories when selling prices are the only available data. The use of this method allows the retailer to mark only the selling prices on the merchandise and eliminates the need for referring to specific purchase invoices.
  - If the retailer also maintains a perpetual inventory, it can determine gross profits and operating income (other than shrinkage) each month without taking a physical inventory.
  - Compare the computed inventory total with the physical inventory total, both at retail prices, to disclose the extent of inventory shortages and the consequent need for corrective measures.
- (7) Retailers using RIM must indicate it used this method on the tax return, keep accurate accounts, and consistently use the method. The following information must be maintained in the retailer's accounting records to perform the necessary RIM computations:
  - The beginning inventory valued at both cost and retail amounts
  - Net purchases priced at both cost and retail; and
  - Net sales for the tax year.

- (8) The retail method may be used in conjunction with the last-in, first-out (LIFO) method of identifying the goods included in ending inventory (discussed below). However, if the retailer uses RIM in conjunction with the LIFO method, it must value inventory at cost (i.e. it cannot use LCM).

### **G.3. Uniform Capitalization Rules (UNICAP)**

- (1) See the Resellers chapter of the UNICAP 263A book on the Inventory and 263A shelf within the Corporate/Business Issues & Credits Knowledge Base in the Servicewide Virtual Library.
- (2) The uniform capitalization rules under IRC § 263A (UNICAP) apply to the determination of cost of property purchased for resale (i.e. inventory), whether real or personal property, in tax years beginning after 1986. For a thorough explanation of UNICAP and how it applies to retailers and wholesalers, refer to Treas. Reg. §§ 1.263A-1 and 1.263A-3.

### **G.4. Last In, First Out (LIFO)**

- (1) See the Inventory LIFO Book on the Inventory and 263A shelf in the Servicewide Virtual Library, along with the following Practice Units:
  - Adopting LIFO
  - LIFO Conformity for U.S. Corporations with Foreign Subsidiaries Using LIFO
  - LIFO Conformity
- (2) Under the LIFO inventory method, taxpayers are allowed to allocate the most recent inventory costs to cost of goods sold while maintaining the earliest costs in inventory. The main objective is to match current income against current costs.
- (3) Under the LIFO method, it is assumed that goods sold in any period are the most recently acquired and goods on hand at the end of the reporting period are the earliest acquired. If the goods on hand at the end of the period exceed the goods on hand at the beginning of the period, the increase in the inventory must be valued at current year cost in the year of acquisition.
- (4) Many larger retailers, such as auto sellers, elect to use the dollar-value LIFO inventory valuation method. Some retailers use the inventory price index valuation method, detailed at Treas. Reg. § 1.472-8(e)(3). For each pool, the index indicates the level of price change that occurs from the beginning of the first fiscal year under the LIFO method. An appropriate index must be used. Most department stores and large discount chains use the price indices published by the Bureau of Labor Statistics (BLS), which has IRS approval.

## **G.5. Stock Ledger (Inventory)**

- (1) This is the principal inventory record used by retailers. It is the perpetual inventory record. It contains a roll-up of summary data from the purchases journal or accounts payable system, the price change records, and the sales journal. It also contains original entry information pertaining to the adjustment of book inventory to physical inventory. In some cases, it will also reflect, between inventories, a manual or automatic entry to accumulate an estimate of the shrinkage to date. As a “memo” inventory, it will usually show a roll-up of merchandise which has been received but not yet charged to the stock ledger.

## **G.6. Point of Sale Perpetual Inventory Control System**

- (1) Many retailers use an automated retail system where the store cash registers are linked to computer processing systems. Merchandise is ticketed with bar code tags, which are scanned and read at the checkout counter. The computer accumulates sales transaction information which is stored electronically. It is input into the sales journal, which is rolled up into the stock ledger.

## **G.7. Inventory Purchases**

- (1) Purchases is typically one of the largest components of Cost of Goods Sold on the books of a retailer.
- (2) When examining purchases, an examiner will complete the following examination steps:
  - Look for nondeductible expenditures in purchases.
  - Scan the account for vendors not associated with the retailer’s products or services. For example, question the taxpayer regarding a purchase of bedroom furniture recorded in inventory purchases of a convenience store.
  - If the examination is expanded to include the owners, look for an absence of personal expenditures in the owners’ bank accounts. For example, if the owners of a small grocery store make no payments from their personal bank account for food purchases, ask whether the owners used grocery store inventory for personal purposes.
  - Scan the purchase entries for unusual payees and amounts.
  - Select some purchases for a sample period and compare journal entries with corresponding vendor invoices and cancelled checks.

## **H. Expenses**

- (1) This section provides general background information about business expenses reported by taxpayers in the retail industry and the general accounting practices for these expenses.
- (2) Retailers incur various everyday costs in operating their principal business of selling goods and services to end-use consumers. In general, many of the costs associated with retailing are fixed. In other words, the costs are not directly associated with any particular sale but are incurred whether or not a sale takes place.
- (3) Fixed costs such as advertising, administration, depreciation, equipment costs, rent, utilities and supervision help to maintain and grow the business.
- (4) During the review of business expenses, the examiner will determine whether the expenses are ordinary and necessary under IRC § 162. The examiner will also determine whether the expense is deductible in the current tax year, under the rules set forth in IRC § 461 and the Regulations thereunder. Finally, the examiner will identify any nondeductible expenses that are disallowed under various IRC sections or costs that must be capitalized under IRC § 263.
- (5) In summary, the examiner should consider the following questions when reviewing a retailer's expenses:
  - Is the reported expense an ordinary and necessary business expense?
  - Is the reported expense a nondeductible personal expense or are there entries for personal expense items within a business expense account (e.g. travel, meals & entertainment, vehicle expenses)?
  - If the reported expense is a business expense, is it deductible or nondeductible?
  - If the expense is deductible, is it deductible in the current year or in a later year? (Is the liability fixed and determinable and has economic performance occurred?)
  - If the expense is nondeductible or not deductible in the current tax year, is the amount reported properly on Schedule M?
  - If the expense is a nondeductible capital expenditure, does the statute provide for a systematic cost recovery of the expenditure?
- (6) Notable expense items for retailers are discussed in more detail in the paragraphs to follow.

## **H.1. Franchise Fees**

- (1) A retailer who owns a franchise ("franchisee") will generally be able to deduct franchise payments as a business expense. Many times, the amount due is

contingent on productivity or use, such as a percentage of sales. A deduction by the franchisee is allowed as a business expense only if the payments are part of a series of payments that are payable not less frequently than annually over the term of the agreement and are either equal in amount or payable under a fixed formula. Other amounts paid or incurred because a transfer, sale, or other disposition of a franchise must be capitalized and amortized over the useful life of the franchise, trademark or trade name. See IRC § 1253 for more information.

## **H.2. Cooperative Advertising**

- (1) For some retail businesses, a vendor may pay a percentage of the cost of ads placed by the retailer. The retailer must either (1) recognize the amount that will be reimbursed as income and deduct the full amount paid as advertising expense or (2) accrue the payment from the vendor at the time the "tear sheet" is sent to the vendor. In other words, cooperative advertising payments should not be reported on the cash basis.

## **H.3. Charitable Contributions and Promotions**

- (1) Many retail grocery businesses give money, inventory, and other donations to charitable organizations to promote their store's image and goodwill in the community. For example, a retailer with unsold holiday merchandise that it has already tried to sell at a discount may donate some or all of the unsold holiday merchandise to a charity. Some stores may deduct these donations as an advertising expense.
- (2) The 2020 Coronavirus Aid, Relief, and Economic Security (CARES) Act modifies the IRC § 170(b)(2) deduction limitation on cash charitable contributions for the 2020 tax year for corporations, raising it from 10% of taxable income to 25%.
- (3) Generally, the amount of a charitable deduction for ordinary and capital gain property is the fair market value of the item contributed, reduced by the amount of ordinary income the donor would have recognized if the item were sold. In other words, the deduction is limited to the retailer's basis in the item. For example, a retailer donates inventory to a qualified charitable organization. The inventory has a fair market value of \$1,000 and a cost of \$400. If the retailer had sold the donated inventory, he would have recognized \$600 of ordinary income. Therefore, the amount of charitable contribution is limited to \$400, his basis in the donated inventory. See IRC § 170(e).
- (4) Inventory donations may include hair products; cosmetics, clothing, day-old bakery items, dented cans of food, old produce and other outdated items to food pantries and other charitable organizations. The examiner must identify the

donated items and verify the contribution was made to a qualifying charitable organization.

- (5) Ordinarily, charitable deductions for inventory items are limited to basis (see the example above). However, retailers that make contributions of inventory may be entitled to what is known as the “enhanced deduction”. This deduction is generally only allowed to C corporations. The amount of the enhanced deduction is equal to the basis of the property contributed plus one half of the appreciation, not to exceed twice the basis. The retailer treats the amount as a charitable contribution and reduces cost of goods to account for the donated inventory and avoid a double deduction.
- (6) To qualify for the enhanced deduction, the donation must meet the specific requirements of IRC § 170(e)(3), which include the following:
  - the donee’s use of the property is related to the purpose or function constituting the basis for its exemption under IRC § 501 and the use must be solely for the care of the ill, the needy, or infants
  - the donee does not transfer the property in exchange for money, other property, or services;
  - the retailer receives from the donee a written statement representing that its use and disposition of the property will be in accordance with requirements 1 and 2 above and
  - if the property is subject to regulation under the Federal Food, Drug, and Cosmetic Act, such property must fully satisfy the applicable requirements of the Act and regulations thereunder on the date of transfer and for one hundred and eighty days (180) prior thereto. IRC § 170(e)(3).
- (7) There are special rules under IRC § 170(e)(3)(C) for contributions of food inventory. First, in addition to the requirements listed above, the food inventory donated must be “apparently wholesome food”. Second, the C Corporation restriction does not apply to food donations. That is, a retailer that is not a C corporation can take a charitable contribution deduction for its contributions of food inventory under this code section. Finally, this code section also contains special rules for valuing food inventory donations. The CARES Act increases the IRC § 170(e)(3)(C) food inventory charitable contribution deduction limit for the 2020 tax year to 25% from the current 15% cap.
- (8) Verification of the food or inventory donation is important as the retailer may take it out of inventory without properly reducing cost of goods sold. Thus, it would be expensed in cost of goods sold at year-end, and would be written off as a charitable deduction, promotion expense, or food spoilage. In addition, inventory written off as a donation may actually be personal use of inventory disguised as a donation. The examiner should verify proper accounting for inventory donations to avoid unallowed deductions and improper write-offs.

- (9) Overall, when examining charitable contributions of retailers, verify the contribution is allowable, and ensure the retailer followed proper procedures in documenting and computing the deduction.

#### **H.4. Accruals**

- (1) A taxpayer on the cash receipts and disbursements method of accounting deducts expenses when paid. However, a taxpayer on the accrual method of accounting can only deduct an expense that is fixed and determinable at year-end and for which economic performance has occurred. Determine whether accrued expenses were properly deducted under IRC § 461 and the regulations thereunder.
- (2) Also, inspect end-of-year accruals to ensure proper cutoffs in accordance with the retailer's taxable year under IRC § 441 (period for computation of taxable income). Many retailers elect a 52-53-week year-end under IRC § 441(f), so their tax year does not necessarily end on the last day of the month.

#### **H.5. Covenants Not to Compete**

- (1) This could be disguised goodwill. Goodwill is an intangible asset as defined in IRC § 197. Don't forget to consider the whipsaw issue between what the taxpayer claims as an expense and the seller claims as a capital gain.

### **I. Depreciation and Cost Segregation Studies**

#### **I.1. Depreciation and Cost Segregation Overview**

- (1) Commercial buildings owned by the business are §1250 non-residential real property and must be depreciated under the Modified Accelerated Cost Recovery System (MACRS) over 39 years. See IRC §168(e)(2)(B). Under the CARES Act, for the 2020 tax year, businesses will be able to depreciate the costs of certain interior renovations as 15-year property, eligible for bonus depreciation instead of using straight-line depreciation over a 39-year period.
- (2) Structural components of the buildings must be depreciated over 39 years. Some non-structural elements of buildings, however, can be separated and identified as tangible personal property. This practice is known as cost segregation. It allows recovery of the personal property elements of a building and the land improvements over shorter recovery periods.
- (3) Personal property (or § 1245 property) may be recovered over a 5-year or 7-year recovery period using the 200-percent declining balance method. Land improvements (Rev. Proc. 87-56, Asset Class 00.3) may be recovered over 15 years utilizing the 150-percent declining balance method. In addition, certain

Qualified Real Property may qualify as 15-year recovery property. See IRC §168(e)(3)(E).

- (4) Personal property elements, identified through cost segregation, may qualify for the IRC § 179 expense deduction and/or bonus depreciation under IRC § 168(k). The segregation of real and personal property may also change state and local taxes imposed on real and personal property.

## **I.2. Cost Segregation ATG**

- (1) A cross functional team developed a Cost Segregation Audit Technique Guide (ATG) for the preparation and examination of cost segregation studies. The purpose of the ATG is to provide examiners with an understanding of why cost segregation studies are conducted, how they are prepared, and what to look for in the review and examination of these studies. The ATG also assists taxpayers and practitioners in understanding what the Service will consider as support for property classification and the associated cost basis established by these studies. It should be noted that this ATG is not an official Service pronouncement and may not be cited as authority.
- (2) IRS originally issued industry specific guidance on the proper asset classification for various assets in the retail and restaurant industries in 2003. These Field Directives on the Planning and Examination of Cost Segregation Issues in the Retail and Restaurant Industries were last updated in December 2007. These asset matrices provide guidance for determining whether retail and restaurant assets are IRC § 1245 property (shorter cost recovery period) or § 1250 property (longer cost recovery period). Prior to the issuance of this guidance, there had been some controversy on audits regarding the appropriate recovery periods used in computing the depreciation deduction for certain industry assets.
- (3) The IRS issued these Industry Directives after soliciting input from IRS examiners, the retail and restaurant industries, and the practitioner community. It was anticipated that the Directives would lessen the areas of disagreement involving asset classification and depreciation recovery period for certain retail and restaurant assets. As a result, both taxpayers and the IRS should experience a reduction of audit costs and examination burden. Although Industry Directives are not official pronouncements of the law or the IRS's position, they provide suggested guidelines resulting in an efficient use of audit time and resources.
- (4) IRS has instructed examiners to not adjust the categorization and lives of an asset if a taxpayer's classification is consistent with the recommendations in the Industry Directive.



### I.3. Suspended Acoustical Ceilings

- (1) When installed in a building, a suspended acoustical ceiling becomes a structural component of the building. The suspended ceiling is not viewed as a temporary covering for the ceiling; it is the ceiling. Thus, suspended acoustical ceilings are structural components ineligible for classification as § 1245 property and do not qualify for the MACRS treatment as 5 or 7-year property.
- (2) The asset matrix for the Cost Segregation ATG Industry Specific Guidance Chapters 7.2 for Restaurant and Chapter 7.3 Retail Industry show the asset term “Ceilings” as including all interior ceilings regardless of finish or décor. The term “ceiling” includes, for example, drywall or plaster ceilings, acoustic ceilings, suspended ceilings (including all hangers, frames, grids, and tiles or panels), decorative metal or tin finishes, kitchen plastic panels, decorative panels, etc. These are all considered § 1250 property and are to be recovered as § 1250 property over the 39 year life of the building.

### I.4. Heating, Ventilating and Air Conditioning (HVAC)

- (1) It is the IRS’s position that HVAC units located in retail stores or supermarkets that serve the building and that do not exclusively serve the freezers and refrigerators within the store are structural components of the building depreciable over 39 years. However, the "sole justification" test specified in the regulations allows retailers to treat separate HVAC units that exclusively serve freezers and refrigerators as personal property depreciable over 5 years.
- (2) The PATH Act of 2015 as well as previous Acts allow interior portions of HVAC systems quicker recovery than the 39-year straight-line if they are Qualified Leasehold Improvement Property and now Qualified Improvement Property. The PATH Act also made HVAC units placed in service after 2015 eligible for §179 expensing.

## J. Other Potential Income Tax Issues

- (1) **Excessive Losses, Not a Trade or Business** – When an individual taxpayer has claimed Schedule C losses over several years from online retail activity which was used to shelter ordinary income from other sources, the examiner should determine whether the retail activity is a business or a hobby. If the activity is a hobby under IRC § 183, the losses are not deductible. In addition, the losses may come from deductions for nondeductible expenses such as personal auto expenses or travel, or incorrect home office allocations. Nondeductible expense items fall under multiple IRC sections including §§ 162 and 262.

- (2) **Tax Shelter** – When a taxpayer uses an IRS-identified, systematic scheme to obtain losses and credits that are not allowable under the IRC (for example, claiming the Americans with Disabilities Act Credit for Website Improvements).
- (3) **Changes in Accounting Method** – A “change in method of accounting” includes a change in the overall method of accounting (e.g. cash or accrual method) or a change in the treatment of a material item. A “material item” refers to any specific item that involves the proper time for inclusion of the item in income or the taking of a deduction (e.g. a change from capitalization to deduction). A change in method may be taxpayer-initiated (i.e. voluntary) through filing of a Form 3115, or the change may be Service-initiated (i.e. involuntary) through an examination adjustment.
- (4) Be aware that any time an examiner proposes an adjustment that changes when an item is reported for tax purposes (i.e. does NOT permanently impact the taxpayer’s lifetime taxable income), it may be an involuntary change in accounting method, and special procedures and rules apply. See the various books on the Methods of Accounting and Timing shelf within the Corporate/Business Issues & Credits Knowledge Base in the Servicewide Virtual Library.
- (5) Leases that do not meet the short-term lease definition of Internal Revenue Code Section 110(c)(2) and 168(i)(3), and its related Regulations - Whether payments received with respect to leases with terms exceeding 15 years are treated as income to the retailer (lessee) will turn on whether the lessee or the lessor is treated as the owner of the property constructed with the construction or “tenant allowance”. (See Exhibit 2, Planning & Examination of Construction “Tenant” Allowances for Leases Greater Than 15 Years.)

## **K. Excise Tax Issues**

- (1) A retailer may be liable for excise tax on its sale of certain articles of sports fishing equipment and archery equipment if it imports the articles in the United States. IRC § 4161(a) imposes a tax on the sale of articles of sport fishing equipment specifically enumerated in IRC § 4162, including any related parts or accessories. IRC § 4161(b) imposes a tax on bows, certain bow parts and accessories, certain quivers, and certain arrow components.
- (2) Examiners should verify that required excise tax returns have been filed. See IRM 4.10.5.10.

## **L. Employment Tax Issues/Information Returns**

- (1) The examiner should check for employment tax return issues (see IRM 4.10.5.5) and should be aware of potential employment tax issues, including issues relating to family members working for closely held retailers.

- (2) Examiners should also verify that required information returns have been filed. See IRM 4.10.5.6.

### III. Chapter 3: Grocery Stores

- (1) The retail industry's grocery segment operates stores that offer a general selection of food products. Grocery stores operate in many different formats, such as small family-owned stores, discount stores, specialty food stores, boutique chains, and large supermarket chain stores. Retailing food products is an increasingly fragmented industry as consumers buy their food from a variety of retailers including drug stores and dollar stores. Grocery stores are also now competing with internet retailers. Most stores operate on narrow gross profit margins.

#### A. Income

- (1) Potential compliance issues typically involve the improper deferral of income and the non-reporting of several types of income common within the industry. Gross receipts are attributable to:

- Food product sales
  - Cash, check, debit card, credit card
  - Coupons and related processing fees
  - Supplemental Nutrition Assistance Program (SNAP), formerly known as Food Stamps
  - WIC Program (Special Supplemental Nutrition Program for Women, Infants and Children)
- Gift certificate/cards
- Lottery sales
- Money orders
- Photo processing
- Prepaid telephone cards
- Promotional programs offered by third parties
  - Cash discounts
  - Rebates
  - Value of vacation trips; and other types of prizes
- Vending machines
- Redemption of bottles and cans
- Rentals of videotapes and DVDs

## **A.1. Food Product Sales - Sales Summary Report**

- (1) Typically, retailers have a sales summary report that shows sales on a departmental basis, the amount of sales tax collected, total sales, other income received, rebates received, and other credit transactions that originate in the stores daily. The report also shows all the daily debit transactions, such as voids, refunds, cash payouts, both store and manufacturer coupons tendered. The debit side will also reflect the amount of daily bank deposit. This report is very helpful in reconciling the dollar amount of coupons debited with the dollar amount credited to the taxpayer's books.

## **A.2. Coupon Income**

- (2) Grocery stores typically accept discount coupons printed by manufacturers of consumer goods to incentivize consumers to purchase their products. Grocery stores should report the selling price of the item as gross income. For example, a grocery store accepts a \$1.00 discount coupon for an item with a selling price of \$10.00. Here, the grocery store should recognize a sale of \$10.00 a coupon receivable of \$1.00, and either cash or credit card receivable of \$9.00 from the customer.
- (3) In addition to the right to receive reimbursement from the manufacturer for accepting discount coupons, grocery stores also receive a "manufacturer's handling allowance" for accepting discount coupons. The purpose of this allowance is to reimburse grocery retailers for the cost of processing discount coupons they accept from their customers. Grocery stores should recognize the "manufacturer's handling allowance" as gross income at the time the sale is made, and the discount coupon is accepted as partial payment for the sale.

## **A.3. SNAP and WIC Income**

- (1) Food stamps were renamed the Supplemental Nutrition Assistance Program or SNAP in 2008. SNAP benefits are for food. As such, SNAP does not cover items like pet food or toiletries. SNAP distributes funds for purchasing food via Electronic Benefit Transfer (EBT) cards. EBT cards are a federally funded payment option offered at participating stores. EBT cards are more discreet because of their resemblance to debit cards. All 50 States, the District of Columbia, Puerto Rico, the Virgin Islands, and Guam use EBT cards.
- (2) In some cases, families receive both SNAP and help from other programs, such as WIC. The WIC program uses specially designed checks. Families can use these checks to purchase essential items such as milk, eggs and baby formula.

## A.4. Gift Cards and Certificates

- (1) The sale of gift cards and certificates is a widespread business practice for grocery stores. In addition to a grocery store's own gift cards, many grocery stores also sell gift cards of other retailers. The sale of a grocery store's own gift card or certificate is an "advance payment." An advance payment must generally be included in gross income upon receipt for tax purposes. However, an accrual method grocery store that sells a gift card or certificate to a customer may defer the sale from immediate income recognition under two exceptions. If the grocery store redeems a gift card or certificate by providing goods or services to the holder, the grocery store can defer recognizing the advance payment from the sale of the gift card or certificate under either the one-year deferral method (i.e., Rev. Proc. 2004-34) or the two-year deferral method of Treas. Reg. § 1.451-5(c).
- (2) The sale of gift cards of other retailers is not an "advance payment." Here, the grocery store receives a commission, typically a percentage of the sale proceeds. For example, a grocery store sells a \$25 restaurant chain's gift card. The grocery store collects \$25 from its customer and remits \$20 to the restaurant chain, assuming the agreement provides for a 20% commission. The restaurant chain is willing to take that \$5 loss on the gift card sale because they will make the money back both through breakage (some gift cards are lost or never redeemed) and through added sales from customers who would normally dine elsewhere.
- (3) In addition to selling gift cards, a grocery store may also provide gift cards or gift certificates to its customers for returned merchandise. Here, the grocery store may treat this as a payment of a cash refund for the gift card and reduce gross receipts. The grocery store should also separately treat the transaction as the sale of a gift card, which the grocery store may defer until the gift card is redeemed. Rev. Proc. 2011-17.

## A.5. Promotional Items

- (1) Owners of grocery stores may receive promotional items such as prizes and/or trips from vendors or manufacturers. Prizes received in the past include televisions, computers, telephones, microwave ovens, lawn furniture, coolers, jackets, video/DVD games and movies, vacation trips; food, beverages, and paper products delivered to their homes, and tickets to professional and collegiate sporting events. Since these promotional items fall outside the normal data stream, they are easily omitted from income. Examiners should be alert to the receipt of promotional items and, where identified, make adjustments needed to increase corporate receipts and report a constructive dividend.

## **A.6. Vending Machines**

- (1) Grocery stores may provide vending machines to supplement sales of food and non-food items. The grocery store may rent space to the vendor and receive a monthly payment or the grocery store may have a contract that pays a percentage of the receipts from the machines. Examiners should determine how the retailer accounts for income received from vending machines, if vending machines are used by the retailer.

## **A.7. Courtesy Account**

- (1) Many grocers maintain a customer courtesy account, a petty cash account, or a similar bank account that is separate from the business' regular bank account. The purpose of this account includes but is not limited to: 1) customer courtesy transactions (i.e. postage, the sale of fishing, hunting, and similar licenses, the handling of money orders, and film development, and recording of rebates), 2) to allow employees to voucher small purchases of supplies for the store, and 3) cashing of customer payroll checks. Examiners should consider inquiring about the handling of a customer courtesy account and the type of transactions handled by the account. Accounts examined contained unreported income items such as coupon redemption checks, the handling fees for coupons, income from the sale of money orders, and service fees for licenses.

## **A.8. Demonstrators**

- (1) Grocery stores oftentimes provide in-store product demonstrations. Grocery stores use in-store product demonstrations for a variety of reasons, which include introducing a new product and creating awareness of product availability. Demonstrators may be independents, provided by agencies, or employees of the grocery store.
- (2) Some grocery stores enter into a written contract with the demonstrator, indicating the store hired the demonstrator on a contractual basis. The grocery store may instruct the demonstrator on specifications by which the demonstrator must adhere, including the inability to hire assistants or replacements. Otherwise, the demonstrator is free to employ his/her own methods in performing the demonstrations.
- (3) Grocery stores do not guarantee demonstrators a minimum amount of work. Demonstrators typically work a maximum of sixteen hours per week, receive a set hourly wage and are paid for each demonstration. Demonstrators may decline a demonstration job offer from the grocery store and their failure to accept a job will not affect their name on the demonstrator's listing. Demonstrators may perform demonstration jobs offered to them by competitors. Grocery stores always provide the product demonstrated. However, grocery

stores may ask the demonstrators to bring some supplies with them. Grocery stores usually reimburse the demonstrators for these supplies.

- (4) Grocery stores may treat demonstrators as independent contractors when the demonstrators are employees. This conclusion is supported by the distinction made in Rev. Rul. 65-188, 1965-2 C.B. 390 and Rev. Rul. 75-243, 1975-1 C.B. 322. The degree of control exercised by grocery stores over the demonstrators here is like the control exercised over interviewers in the two revenue rulings. Examiners should consider these revenue rulings when reviewing the grocery store's tax treatment of in-store demonstrators. Examiners should be aware that grocery stores may net demonstrators' wages under promotional income, therefore, avoiding employment taxes.

## **B. Cost of Goods/Inventory**

- (1) The primary function of a grocery store is the buying and selling of goods. Goods in inventory generally represent the most significant asset on a grocery store's balance sheet. Likewise, cost of goods sold generally represents the largest single item of expense. At the same time, Inventory is the asset with the highest probability of being incorrectly valued because the computation involves judgments and estimates. Examiners should keep in mind that grocery stores benefit from shifting outlays from inventory to cost of goods sold as quickly as possible.

### **B.1. Retail Inventory Method (RIM)**

- (1) See INV PN Virtual Library - UNICAP - Resellers
- (2) Grocery stores may approximate cost or lower of cost or market (LCM) of the goods in ending inventory by using the retail inventory method. However, only the largest grocery stores generally use this method.
- (3) Grocery stores may apply the RIM to a department, a class of goods, or a stock-keeping unit. The RIM uses the relationship of retail selling price to cost to determine the cost of merchandise in ending inventory. RIM is an averaging method and has historically been more convenient for most types of merchandise, especially as volume increases. Under RIM, the value of ending inventory is determined by multiplying a cost complement by the retail selling prices of the goods on hand at the end of the taxable year. The numerator of the cost complement is the value of the beginning inventory plus the cost of purchases during the taxable year. The denominator is the retail selling prices of beginning inventory plus the initial retail selling prices of purchases. The denominator is adjusted for all permanent markups and markdowns to value inventories at cost. Regulations prohibit a grocery store from using the RIM to reduce the numerator for sales-based allowances.

## **B.2. Last In First Out (LIFO) Method**

- (1) See the Inventory LIFO Book on the Inventory and 263A shelf in the Servicewide Virtual Library, along with the following Practice Units:
  - Adopting LIFO
  - LIFO Conformity for U.S. Corporations with Foreign Subsidiaries Using LIFO
  - LIFO Conformity
- (2) Many larger Grocers will elect to use the dollar-value LIFO inventory valuation method described in Treas. Reg. § 1.472-8. Treas. Reg. § 1.472-8(c) describes the principles for establishing pools for Grocers. In general, items of inventory in the hands of Grocers are placed into pools by major lines, types, or classes of goods. Once the pools are established the Grocer may elect a LIFO method under Treas. Reg. § 1.472-8(e) to value the pools of inventory for example, the double-extension, link chain or Inventory price index computation (IPIC) method.
- (3) The use of the IPIC method is detailed at Treas. Reg. § 1.472-8(e)(3). For each pool, the index indicates the level of price change that occurs from the beginning of the first fiscal year under the LIFO method. An appropriate index must be used. Most department stores and large discount chains use the price indices published by the Bureau of Labor Statistics (BLS), which has IRS approval.
- (4) In addition, a grocer may use the retail LIFO method. The main difference in the retail method is the use of retail sales values in addition to cost in recording inventory input and output. The retail value of the closing inventory is converted to cost by applying a factor reflecting the relationship of these values to cost, computed by comparing the total retail value and cost of purchases during the year.
- (5) A retailer may determine its annual-inflation index under a traditional dollar-value technique (double-extension or link chain) or by using indexes published by the government.

## **B.3. Vendor Allowances**

- (1) Trade promotion is an important component of the sale and marketing of merchandise in the grocery industry. Vendor allowances represent incentives paid by manufacturers and a key component of trade promotion. Grocery stores may receive allowances for a host of different pricing, competitive, and other reasons, with the overall goal of creating an immediate sale. Vendor allowances



also help grocery stores maintain their profit margins. The allowances detailed below are commonly used in the grocery industry.

- (2) Examiners should consider requesting a list of the grocery store's suppliers and request the taxpayer to indicate the supplier(s) who provided rebates as well as the frequency of receipt to identify transactions involving vendor allowances. Examiners should consider checking the grocery store's books and records, including deposit slips to verify the taxpayer's statements.

#### **B.4. Cooperative Advertising**

- (1) In a typical cooperative advertising arrangement, a grocery store provides advertising services (e.g. weekly circulars/flyers, newspaper inserts; in-store signs) and vendors compensate the grocery store in the form of an advertising allowance. Essentially, cooperative advertising represents shared advertising.
- (2) An advertising allowance that is contingent on the grocer's performance of advertising services is not a trade or discount, which adjusts the purchase price of merchandise. Rather, the advertising allowance is considered a separate item of gross income under IRC § 61. Grocery stores should accrue an advertising allowance as gross income when it places the advertising and not when it submits a claim to the vendor for reimbursement.

#### **B.5. Sales-Based (a/k/a scan-based)**

- (1) The term "sales-based allowance or chargeback" means an allowance, discount, or price rebate that a grocery store is unconditionally entitled to by selling a vendor's merchandise specified by the vendor to specific customers at a price determined by the vendor.
- (2) In a typical sales-based chargeback arrangement, a vendor agrees to reimburse a grocery store for offering a temporary reduced sales price during a promotional period. The chargeback is based on the specific number of units of merchandise sold during that period, rather than the number of units of merchandise purchased by the grocery store. Essentially, the vendor's sales-based chargeback is passed directly on to the consumer in the form of a temporary price reduction (TPR) for the specified merchandise. A sales-based vendor chargeback decreases cost of goods sold. The chargeback does not reduce the cost of goods on hand at the end of the taxable year. Treas. Reg. § 1.471-3(e).

#### **B.6. Slotting (Shelving)**

- (1) Narrowly defined, a "slotting allowance" is a one-time, lump sum payment to a grocery store by a supplier in exchange for which the grocery store allocates retail space for the supplier's products, often new products. However, "slotting

allowance” has been used to cover a wide range of practices between suppliers and grocery retailers relating to product or category management. These include payments by suppliers to grocery stores for preferential display space, the right to be the exclusive (or nearly exclusive) supplier of a product, to control the amount of time a product will remain on the shelves and to keep an existing product on the shelf in the face of competition.

- (2) Slotting allowances first appeared in the grocery industry during the 1970s when cigarette companies began bidding for end-cap display space. Since then, slotting allowances for both new and established products have become more pervasive, increasing in size and covering a larger number of grocery products. A slotting allowance generally binds a grocery store to provide shelf space for a period of six months to one year.
- (3) The value of limited shelf space is important to grocery stores that operate on narrow margins. More importantly, not all shelf space is the same. Areas of high consumer traffic are much more valuable than low traffic areas. Slotting allowances are often contingent on obtaining the best shelf space. As such, the payment of a slotting allowance enhances the visibility of a supplier’s product. If certain criteria are met, slotting allowances may be deferred as advance trade discounts (i.e., inventory reductions). Rev. Proc. 2007-53.

## **B.7. Upfront Payments**

- (1) As previously noted, a manufacturer may enter into a long-term exclusive (or partially exclusive) supplier agreement with a grocery store. These types of arrangements are almost always supported by a written contract. Typically, these contracts provide for a large up-front from the manufacturer to the grocery store. These arrangements have been observed in certain product categories, such as food spices, greeting cards, tobacco products and lighting products. This list is not all-exclusive, so examiners need to be alert to the fact that long-term arrangements may exist for other products.
- (2) When examining a grocery store operation, consider performing the following checks on purchases and inventory:
  - Request specific invoices to analyze (i.e., larger material amounts, unusual payees and invoices of main suppliers). Note any errors found. Become familiar with suppliers billing invoices; what items are included in them; and where they are included (i.e., capital item purchases, trips, etc.).
  - Request a supplier list from the taxpayer. Analyze the list of major suppliers provided by the taxpayer, noting which supplier pays rebates and how often. Analyze the general ledger per sales (credits) and cost of goods (credits) for rebates reported.

- Note any patterns of reporting the rebates (i.e., credits to sales, credits to cost of goods); considering when they are being reported (i.e., weekly, monthly, semiannually, yearly, etc.).
- Compare the rebate list to patterns found. Question the taxpayer as to what type of programs or agreements they have with the suppliers that rebate (such as contracts; deal sheets; shelf space, slotting, or volume agreements, etc.).
- Note if IRC § 263A applies. Verify, through probing, whether the taxpayer included rent, utilities, insurance, taxes on storage facilities, purchasing and management salaries, supplies, telephone, travel, or other IRC § 263A expenses in the amount capitalized. Be aware of the \$10,000,000 exception rule for small businesses.

## **C. Expenses**

### **C.1. Advertising or Contribution**

- (1) Some grocery stores offer a program that sets aside proceeds from sales for donation to various public interests and charitable organizations in cities where the sales occur. For example, a program may earmark funds for use in projects that improve the local community. Whether payments from these types of programs represent an advertising expense or a charitable contribution depends on whether the payments are completely gratuitous or whether they bear a direct relationship to the grocery store business and are made with a reasonable expectation of a financial return that is commensurate with the amount of the payment. The distinction only makes a difference where the grocery store's deduction for charitable contributions is limited by its taxable income.

### **C.2. Depreciation**

- (1) Grocery stores are prime candidates for cost segregation studies. A cost segregation study segregates a store's building components into shorter depreciable recovery periods. The result of a cost segregation study is an acceleration of depreciation deductions and lower taxable income. In a typical cost segregation study, construction costs are reclassified from a 39-year recovery period to the shorter 5-year, 7-year and 15-year recovery periods. Cost segregation applies to both owned and leased stores. Examiners should consider consulting the IRS Cost Segregation Audit Techniques Guide, including a matrix for retail, to assist with determining the proper classification of grocery store property.

### **C.3. Domestic Production Activities Deduction (DPAD)**

- (1) The American Jobs Creation Act (AJCA) of 2004 (P.L. 108-357) codified IRC § 199. This tax provision, entitled, Income Attributable to Domestic Production Activities, was effective for tax years beginning after December 31, 2004. The Domestic Production Activities Deduction (DPAD) is a deduction equal to 9%

(3% in the case of taxable years beginning in 2005 or 2006, and 6% in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of a taxpayer's qualified production activities income (QPAI) or a taxpayer's taxable income for the tax year.

- (2) DPAD has been repealed for tax years beginning after December 31, 2017 pursuant to Public Law 115-97 (as amended by the Consolidated Appropriations Act, 2018, P.L. 115-141, § 101(c), 131 Stat. 350, 1151, 1156).
- (3) For more information on DPAD, see the IRC § 199 book on the Corporate Issues shelf within the Corporate/Business Issues & Credits Knowledge Base in the Servicewide Virtual Library.

#### **C.4. Donation of Inventoriable Goods**

- (1) Charitable contributions of food inventory are common within the grocery industry. For example, many grocers regularly contribute food inventory to charitable organizations, such as local food banks. Taxpayers are generally limited to claiming a tax deduction equal to the basis of the contributed property. Special rules, however, provide an enhanced deduction in the case of "qualified contributions" of inventory. IRC §170(e)(3). The enhanced deduction applies only to donations of property that are used by the donee solely for the care of the ill, needy, or infants. The IRS will not challenge a taxpayer's choice of applying the general rules (i.e., IRC § 170(e)(1)) to donations which otherwise qualify for the enhanced deduction. IRS Notice 2008-90.
- (2) The first step to determine the deduction for the contribution of food inventory is to determine the Fair Market Value (FMV) of the food. IRC §170(e)(3)(C). When a grocery store claims the enhanced deduction, it is appropriate to consider whether the FMV was appropriately determined. CCA 201012061. The enhanced deduction equals the basis of the property plus half of the ordinary gain if the property had been sold, but this amount cannot exceed 200% of the basis. Trade discounts and other allowances must be considered in computing the basis of the property. FAA 20113801F.

#### **C.5. Franchise Fees**

- (1) A grocery store owner who purchases a franchise will generally be able to deduct franchise payments as a business expense. Oftentimes, the franchise fee is contingent on productivity or use, such as a percentage of sales. The franchisee can deduct franchise fees as a business expense only if the fees are part of a series of payments that are payable not less frequently than annually over the term of the agreement and are either equal in amount or payable under a fixed formula. Other amounts paid or incurred because transfer, sale, or other disposition of a franchise must be capitalized and amortized over the useful life of the franchise, trademark, or trade name. IRC § 1253.

## C.6. Reward Programs (Loyalty Points)

- (1) Price rebates, store coupons, and other promotional incentives, such as reward programs are used by grocery stores as marketing tools for attracting and retaining customers. In a typical customer reward program, a grocery store owner provides customers, who are members of its reward program, with points earned based on the volume of the member's transactions. Customers can redeem their accumulated loyalty points for future purchases at the grocery store.
- (2) The primary issue is when an accrual-method grocery store may consider the cost of future redemptions. Accrual-method grocery stores cannot deduct the unredeemed value of loyalty points at taxable year-end. Rather, a grocery store may deduct the value of loyalty points in the taxable year when the grocery store's customers redeem them. Giant Eagle, TC Memo 2014-146.

## C.7. Store Remodeling Costs

- (1) Grocery stores regularly incur expenses to remodel or refresh their establishments to stay competitive and remain attractive to customers. However, because these projects often involve repairs and improvements to many different building components, analyzing what costs can be deducted and what should be capitalized can be a complicated task.
- (2) The tax treatments of these costs often are questioned on audit. Historically, a decision to deduct these costs as repairs was often based on the dollar amount of the expenditure or the amount of the invoice. The IRS often sought to categorize these expenditures as 39-year recovery property.
- (3) For calendar year taxpayers, new "repair" regulations issued September 13, 2013, became effective January 1, 2014. The new regulations, while complex, are generally more favorable to grocery store owners remodeling stores than the prior rules. Many of the concepts used in a cost segregation study also apply to the application of the new repair regulations. To eliminate disputes, the IRS developed simplified rules to determine the currently deductible portion of remodeling costs and the portion of remodeling costs that must be capitalized and depreciated as improvements. The safe harbor allows grocery store owners to deduct 75% of qualifying expenditures paid or incurred to remodel or "refresh" qualified buildings and capitalize the remaining 25%. Rev. Proc. 2015-56.

## C.8. Other Considerations

- (1) Since grocery store owners are in a position of control, owners may consume inventory personally. The arrangement by which an owner treats the "purchase" of the inventory personally consumed may vary in scope. For example, an owner may account for the "purchase" of inventory personally consumed by:
  - writing personal checks for the purchases;
  - making adjusting entries in the books and records,

- treating the purchases as “loans” from the business,
  - treating the purchases as “fringe benefits” to the owners,
  - treating the purchases as additional wages at the end of the year, or
  - not accounting for personal use at all. An examiner should consider how the owner accounts for the inventory personally consumed.
- (2) In addition to the personal consumption of inventory, examiners should consider reviewing other expense accounts for personal items. Other expense accounts examiners may want to consider include, but are not limited to, vehicle, travel, dues, meals and entertainment.

## **IV. Chapter 4: Electronic Business & Online Retail**

### **A. Introduction**

- (1) Generally, electronic business, or e-business, consists of business transactions conducted over open computer networks. To most people, e-business implies online shopping, but web shopping is only a small part of the e-business picture. E-business also refers to other business transactions including online stock and bond transactions, business-to-business purchases (EDI), and electronic telemarketing.
- (2) There are a significant number of taxpayers involved in online retail, including online sales of specialty items, music, books & magazines, electronics & appliances, computer hardware & software, and clothing.
- (3) Since the advent of the internet, individuals and businesses both large and small can participate in e-business. The internet has also changed the way that many retailers have traditionally conducted their business. Retailers are now involved in multi-channeling, where a portion of the business is still conducted at the traditional “brick and mortar” establishments and some business is conducted on the internet. Many retail and service businesses use the internet for advertising for their traditional businesses, but the sales transaction of the product or service is not completed online.

### **B. Identification of E-Business Cases**

- (1) When first assigned a return for examination, the examiner may not know immediately whether a taxpayer has an e-business. The return, however, may have some e-business indicators. The most obvious indicator on a tax return may be the business name. If .com or .net is a part of the name or if the name is preceded by www, the business is likely to be in e-business. Another indicator may be found in the explanation of the business activity (product or service). Internet businesses may use words such as internet service provider, web host, web design, web master, or online in the descriptions.

- (2) Review the instructions for the preparation of Forms 1040 Schedule C, 1120-S, 1065, and 1120 with respect to the “Business Code” line item for each form. This code is referred to as “Codes for Principal Business Activity and Principal Product or Service” and is based on the North American Industry Classification System (NAICS). E-business returns may be identified using the NAICS codes listed in the table below.

<b>Forms</b>	<b>NAICS Code</b>	<b>Explanation of Business or Products</b>
1120, 1065, 1120S, 1040/Schedule C	425110	B2B Electronic Markets
	454110	Electronic Shopping & Mail Order Houses
	454113	Mail-Order Houses
	511210	Software Publishers
	519130	Internet Publishing & Broadcasting & Web Search Portals
	517919, 517910	Internet Service Providers
	517110	Wired Telecommunications Carriers
	517210	Wireless Telecommunications Carriers (except Satellite)
	518210	Data Processing, Hosting & Related Services
	541511	Custom Computer Programming Services
1040/Schedule C	541512	Computer Systems Design Services

Forms	NAICS Code	Explanation of Business or Products
	541513	Computer Facilities Management Services
	541519	Other Computer Related Services
	454112	Electronic Auctions
	454111	Electronic Shopping

(3) Expenses contained in the Other Deductions line item may also be indicators of internet business activity. Below is a list of expenses that a business with a website might incur. (Note - some of these costs may be subject to capitalization under IRC § 263(a) and/or IRC § 195)

- Web site design costs
- Domain name registration fees
- Web maintenance costs
- Internet service provider fees
- Cable modem access costs
- Web page hosting fees
- Web consulting fees
- Domain name cost
- Network service fees

(4) Many tax returns contain a supplemental depreciation schedule. Assets included on the depreciation schedule may also indicate that the retailer has an internet presence. These assets may include the following:

- Servers
- Significant computer purchases
- Computer Software
- Modems
- Routers
- Telecommunication equipment
- Phone Lines
- Domain name



- Web site design costs
  - Switches
- (5) An unusually large amount deducted for Rental/Leasing Expense and/or Utilities may also be indicators that the company is involved in internet activity. Some taxpayers do not have the capital necessary to fund the initial investment for equipment and peripherals needed for internet sales. These taxpayers rent or lease the equipment and peripherals as an alternative.
- (6) If there are no indicators on the return or if the indicators are not conclusive, there may be other ways to determine if the retailer is involved in e-business. Here are some suggested audit techniques to help make that determination:
- As part of the pre-audit, research the retailer owner's name, business name, or phone number using a search engine such as Google®, Bing®, or Yahoo® to determine whether the taxpayer has web page listings. Be alert for multiple listings.
  - During the initial interview, ask the retailer if it has a website (see Interview Questions section).
  - Look in the yellow pages (online at [www.yellowpages.com](http://www.yellowpages.com)) to see if the retailer advertises a website.
  - Review an employee's or owner's business card. Business cards will often include the name of a website or will include an e-mail address. If the domain name included in the e-mail address is similar to the retail business name, then it is very likely the retailer has a business web site.
  - Look for deductions that are common for e-business. For example, website development costs paid for software used to create a website or to an application service provider, depreciation deductions for web servers or networking equipment, and payments to internet access providers.
- (7) After the examiner has determined the retailer has an internet presence, the examiner should save the current website content for documentation in the case file. Saving the website content before the retailer closes the site or limits access to it may be important to the development of an unreported income case involving online retail sales.
- (8) The examiner may also be able to use the website to identify possible issues to examine, third-party contacts to make, related websites to visit, and other possibly undisclosed businesses and relationships.
- (9) There are also some internet investigative tools available to assist examiners in their e-commerce examinations. For instance, the examiner can do the following:
- Perform a **LinkPopularity** search (on [www.linkpopularity.com](http://www.linkpopularity.com)) to identify websites linked to the retailer's site. Related websites and other websites under the retailer's control may be other possible sources of income.

- Search the Internet Archive's Wayback Machine\* (at <http://archive.org/web/web.php>) for the retailer's website.
- (10)\*The Internet Archive is a database of archived webpages dating back to 1996. The search interface for the Internet Archive is the Wayback Machine. The results displayed will show all archived copies of the website available. This search will allow the examiner to determine what the website contained during the year of examination as well as other historical information regarding the retailer. For example, historical website information may show when the online business was started and/or what product lines were sold online during the exam year.
- (11)Once the audit has started, the most obvious way to find out if the retailer is involved in e-business is to ask. It is important to ask even if there are no indicators of an online presence.

## **C. Interview Questions**

### **C.1. E-Business Online Retail & Services Interview Questionnaire**

- (1) The interview is a key part of an e-commerce exam, just as it is in examining any other type of business. Below are some examples of interview questions an examiner should consider asking when talking to a retail taxpayer that may be involved in e-commerce. (See Exhibit 1 for a more detailed explanation of the reasoning behind these questions.)
- Do you have an internet presence (web site, web page, e-mail, ad banner) for business purposes?
  - Do you conduct business transactions over the internet? (e.g. Do you accept orders and/or payments over the internet?) If so, what types of records do you maintain for these transactions? (All electronic? Paper documents?)
  - What products, services or memberships may customers purchase on your web site or through email?
  - When was the web site "opened" for business? Did the business exist prior to creation of the web site? Is the business you conduct over the internet separate or distinct from your historic line of business?
  - What domain names are registered to your business (either by you or on your behalf)? What domain names do you have control over? Please provide the date of registration and the name of the registrant.
  - How is the fee for internet connection services determined?
  - How did you develop your web site (i.e. outside consultant, internal staff, web site design software)? (Note to Examiner: If you determine that these web site development costs are an issue for exam, consider requesting details regarding consulting fees, design fees, employee salaries, non-employee compensation, design software, etc.)

- How many employees are engaged in the internet-based business activity? (If applicable & necessary, secure a list of the employees, job titles, compensation, etc., responsible for web site design and web site hosting.)
- What type of credit cards do you accept from consumers making online purchases?
- What is the name of the financial institution(s) that clears your credit card receipts? Did you complete an application or merchant services sign-up form for the credit card clearing services?
- Does your internet service provider or the entity that is providing you server space process your credit card transactions?
- Have you used any other financial institutions in conjunction with your internet business?
- Does your financial institution(s) provide any of the following services?
  - charge authorization
  - transaction capture
  - settlement
  - charge-back handling
  - reconciliation
  - reporting, or
  - prepaid card issuance and acceptance
- What type of purchase payment enabling software do you use? (Make note of the vendor name and address. If the taxpayer does not know the name of the software, ask if the ISP hosting the web site is providing the software.)
- How are credit sales handled and how are they recorded in gross receipts?
- How are non-credit sales handled and how are they recorded in gross receipts?
- What is the process for authorizing and approving credit card purchases?
- What is the sequence from order entry to shipment?
- How are products shipped and which shippers are used?
- Who are your major suppliers and vendors?
- Where do your shipments come from?
- Do you have any paid referral or advertising contracts with other web sites? (If the answer is yes, obtain copies of the contracts.)
- Do you swap (barter) links, banner space and server space with any other businesses?

- Do you have any foreign operations?
- Do you have direct or indirect control over any foreign corporations, foreign partnerships, foreign trusts or any other foreign business enterprises?

## **D. Income**

- (1) There is a potential for omitted income in e-business, due to the borderless and paperless feature of the industry.
- (2) The examiner should ask the retailer to explain its online sales procedures. For example, can an order be placed on-line and payment submitted on-line? What type of payment is accepted? What type of sales transactions are conducted online?
- (3) Based on the retailer's responses to various income-related questions, the examiner should determine the best method for verifying income from online sales. It is important for the examiner to review the retailer's web pages for e-payment sources such as PayPal, Venmo, and credit cards, then tie those sources to the books and records and then on to the tax return. This is an important audit technique for online retail. Look for those items of income that should be on the return but are missing. Evidence of an unreported online business can also be found by tracing credit card payments or following up on invoices from website service providers.
- (4) Most businesses that operate a website will receive advertising income for banner ads and pop-up ads that appear on the website. Additionally, each time a site visitor clicks on the ad, the site owner receives another fee. Consider asking how the taxpayer accounts for this advertising income. Many times, there is a counter on the site that indicates the number of visitors, which would give the examiner an idea of the amount of traffic the site receives. Similarly, the examiner can estimate the number of times a banner or pop-up ad is accessed. Based on the ratio and the fee charged per access, the examiner can then estimate related advertising income.
- (5) IRM 4.10.4.3.7 contains the minimum income probes for e-commerce and provides other income examination steps and techniques, including techniques for examining electronic records. Point-of-Sale software issues (ZAPPER) and commercially available accounting software with easily edited electronic tax and accounting records are discussed elsewhere in this guide. Examiners must be vigilant for any indications of income or expense record manipulation by the taxpayer.

## **E. Cost of Goods Sold**

- (1) Cost of goods sold exam techniques for e-business retailers are similar to those for brick and mortar retailers. However, since e-businesses have no fixed location, shipping costs will likely be high, and the examiner may question the retailer regarding shipping methods used (FedEx, USPS, UPS, etc.). One

indicator of potential issues with business-to-business internet purchasing is when the “ship to” address is different from the “purchaser address”. This may be indicative of a more complex business structure that could involve possible related entities or an offshore aspect to the examination.

## **F. Expenses**

- (1) Some expenses of an online retail business will be different from a brick and mortar business, but the same tax laws generally apply.
- (2) Online purchases present a challenge as usually there is no evidence other than an electronic record, which can be manipulated. The examiner should test electronic records for accuracy and scrutinize any adjusting entries. If the books and records appear questionable and internal control is lacking, the examiner may consider third-party contacts to substantiate significant and/or recurring expense items.
- (3) The tax treatment of the following e-commerce related items may result in potential tax issues. Many of these potential issues are related to capitalization versus expensing and timing of deductions.
  - Business Start-up Costs (internet business)
  - Acquisition of Domain Name(s)
  - Acquisition of Hardware
  - Acquisition of Intangibles, including Costs of Production of Literary Content, Graphics, Sound or Video
  - Acquisition of Software and Software Development Costs
  - Lease Expense
  - Catalog Costs (not usually – the catalog’s useful life must first exceed 1 year)
  - Research & Experimental Expenditures and Credit
  - Website Development Costs

### **F.1. Business Start-Up Costs**

- (1) If the retailer incurs any costs related to a start-up or a new business, IRC § 195 may apply. “Start-up expenditures” are not immediately deductible but are generally amortized and deductible over 60 months.

### **F.2. Research & Experimental Expenditures and Credit**

- (1) The term “research and experimental expenditures” is defined in Treas. Reg. § 1.174-2 and generally includes expenses incurred in connection with a trade or business which represent research and development costs in the experimental or laboratory sense. The term includes all such costs incident to the development or improvement of a product. IRC § 174(e) requires that the

expenditure must be reasonable under the circumstances. Treas. Reg. § 1.174-2(a)(6) explains that an amount is reasonable if the amount would ordinarily be paid for like activities by like enterprises under like circumstances. An unreasonable amount may be characterized as a disguised dividend, a gift, a loan, or a similar payment.

### **F.3. Website Development Costs**

- (1) Businesses that decide to sell goods or services over the internet must set up a web presence and incur website development costs. These costs include planning and design, obtaining a domain name, creating a web presence (commonly using website templates and HTML to build web pages containing text, links, images and/or audibles), and maintaining and updating the website. The tax treatment of such costs as either immediately deductible or capitalized and amortized is determined by the nature of the activity.
- (2) Website development may be done in-house, by an outside contractor, or a combination of both. Contractors offer various packages at different prices for different levels of services. The packages differ depending on the number of pages and words, number of photos embedded, number of links, reciprocal linking, the type of contact with major search engines (e.g. Google, Yahoo!, etc.), the type of hosting and backup of data services, and the type of website maintenance.
- (3) Private Letter Ruling 200236028 (June 4, 2002) provides guidance that may be applicable to the issue of website development costs when outside contractors are hired. In this PLR, a taxpayer acquired the Enterprise Resource Planning (ERP) software for its overall financial accounting system and engaged consultants to implement the ERP package and customize the templates for the taxpayer's specific needs. The consultant also developed software and conducted employee training. The taxpayer hired a second consultant as the project manager. A third consultant was hired for additional training, software design enhancements, and technical issue resolution.
- (4) Under the facts of the PLR, the functional consulting costs, employee training costs, and maintenance expenses are deductible under IRC § 162. Employee wages are also generally deductible under IRC § 162. The cost of purchased ERP software is a capital expenditure pursuant to IRC § 263(a). See also Rev. Proc. 2000-50 § 6.01(2). The amortization period of purchased software is computed by using the straight-line method over 36 months, beginning with the month the software is placed in service. See IRC § 167(f)(1)(A).
- (5) The treatment of technical consulting costs requires more analysis into the nature of the work performed and depends on which party was responsible for developing the new software. The PLR refers to Rev. Proc. 2000-50, sections 5 and 6, in the determination of whether technical consulting costs are software development costs or costs associated with the purchased software. If the taxpayer is the sole responsible party for the creation and performance of the software project covered by the consulting contracts, and the taxpayer's

technical consulting costs meet the definition of computer software in the Rev. Proc. 2000-50, such costs will constitute the taxpayer's developed software costs. Rev. Proc. 2000-50 also provides guidance on the treatment of software development costs if a consultant did not create the website. The costs of a self-created website in many respects resemble research and experimental (R&D) expenditures that fall within the purview of IRC § 174. Therefore, website development costs for a self-created site are treated for tax purposes similarly to R&D expenses, and a taxpayer may treat these costs as deductible expenditures. See IRC § 174 and Treas. Reg. § 1.174-2 for more information on R&D costs.

- (6) In summary, the types of expenditures incurred, and the nature of the work performed are important factors in determining the tax treatment of website development costs. Generally, a taxpayer should capitalize purchased software and the associated costs of implementation and installation.

## G. Other Potential Tax Issues

- (1) **Failure to Report or Failure to File** – The examiner has information indicating that the taxpayer has an online retail site but cannot ascertain how the proceeds were reported. The taxpayer hasn't filed a Schedule C, or other business (corporate, partnership) returns reporting income and expenses from the retail activity. The examiner may need to determine tax liability using indirect methods, third-party contacts and/or summonses.
- (2) **Omitted Online Retail Sales** – A retailer may omit an entire income stream, such as the online retail segment of an established traditional retail business, to understate income. Thus, it is important to use the internet investigative tools and techniques discussed earlier to determine whether a traditional brick and mortar retail business also has an internet presence.
- (3) **of Limited Liability Companies (LLCs) and Trusts structures and no 1040 returns filed.** This is a known scheme involving online retail and online services businesses. An online retail business forms an LLC with multiple owners (i.e. treated as a partnership for tax purposes). The partners are Grantor Trusts, and the grantor trust (i.e. individual) partners do not file 1040 returns. (For tax years ending prior to 1/1/2018, this structure results in TEFRA partnership treatment for the LLC. However, the Centralized Partnership Audit Regime Field Exam Procedures, referred to as "BBA", repealed and replaced TEFRA effective for Partnership Tax Years beginning 1/1/2018. Determination of which Audit Regime applies to partnerships under examination is of critical importance.)

## H. Glossary

- (1) **B2B** – Business to business transactions, such as making online purchases from supplier
- (2) **HTML** – Hypertext Markup Language

- (3) **IP** – Internet protocol
- (4) **ISP** – Internet Service Provider
- (5) **POP** – Point of presence
- (6) **www** – World Wide Web

## **V. Chapter 5: Retail Liquor Sales**

### **A. Introduction**

- (1) The basic merchandise carried by liquor stores is wine, liquor, and beer. The stores also may carry some, if not all, of the following: cigarettes, soda, chips and other snacks, drink mixes, cheeses, and bottled water. Many upscale liquor stores have extensive wine departments with a wine expert on hand. Some small liquor stores are more of a grocery store than a traditional liquor store.
- (2) The industry has a three-tiered system for the distribution of its products. The first tier is the manufacturer, the second tier is the distributor or wholesaler, and the third tier is the retailer. The manufacturer may or may not be in the same state as the retailer. Each state controls what products may be brought inside its borders. The distributor or wholesaler sells and distributes the products to the retailers.
- (3) Responsibility for licensing the sale and distribution of alcoholic beverages is shared jointly, although not equally, between municipal, state, and federal authorities. Administration of the Federal Alcohol Act is vested in the Treasury Department in the Division of the Federal Alcohol Administration. In some rare instances, a license is required from only one of these authorities. In most cases, there are dual license requirements.

### **B. Income**

- (1) Of course, the main source of income from a liquor store is typically from alcohol sales. However, the following are other sources of receipts commonly seen in liquor stores:
  - Other grocery sales (e.g. cigarettes, snacks, candy)
  - Lottery sales
  - Check cashing & customers' payments on account

#### **B.1. Other Grocery Sales – Cigarettes, Snacks, Food & Candy Items**

- (1) These sales are subject to state sales tax. The examiner can compare gross receipts from these items reported on the federal income tax return to receipts reported on the state sales tax returns. In many instances, the states examine liquor stores more frequently than the IRS. Therefore, it is prudent to ask the retailer for all recent state sales tax audit reports and to contact the state agency for further information if necessary.



## **B.2. Check Cashing and Customers' Payments on Account**

- (1) Retail stores do not cash checks as a courtesy; they are in business to earn a profit. Many retailers allow customers to write checks for more than the amount of purchase and then pay the customer the difference in cash. For example, if a customer's total due is \$20 and the customer writes a check for \$30, the retailer gives the customer \$10 in cash. Similarly, a customer may charge an amount more than her purchase to a debit card and will get cash back from the retailer. In these situations, the retailer usually does not charge a fee. However, when a customer cashes third party checks such as payroll checks or government welfare benefit checks, the retailer customarily charges a fee based on a percentage of the check amount, even if the customer also makes a purchase. Some state laws dictate a maximum percent/amount that can be charged.

## **C. Cost of Goods Sold**

- (1) In most states, liquor stores may purchase goods for resale only from authorized distributors and not from discount or warehouse stores. The examiner should consider using a percentage markup on cost method when examining cost of goods sold. If cost of goods sold is underreported and the retailer is unable to provide accurate records to support its deduction, the examiner can make third-party contacts to the distributors.

## **VI. Chapter 6 : Mobile Food Vendors**

### **A. Introduction**

- (1) Mobile food vendors are on many busy city street corners, outside of stores and shopping centers, and at fairs or festivals. They may be small mobile stands, trailers or food trucks, which have recently become quite popular. There are two basic types of food trucks, hot trucks and cold trucks. Hot trucks, such as Mobile Food Preparation Vehicles (MFPV), prepare food as customers order. Cold trucks, such as Industrial Catering Vehicles (ICV), sell only prepackaged foods.

### **B. Income**

- (1) Some mobile food vendors operate strictly in cash while others take both cash and credit or debit card payments. Many have weak or no internal controls, so there is potential for unreported income. Accordingly, gross receipts will usually be the focus for the examination. The examiner will likely see large cash deposits to the business bank account. To verify all cash is deposited or accounted for, the examiner must analyze the markup percentage. The examiner should expect to see a consistent markup percentage of about 100% on cold foods sold and about 200% on hot foods sold. For example, if an item is purchased for \$0.50, it will generally sell for \$1 or more.
- (2) If the examiner or vendor uses bank deposits to calculate gross receipts, any cash the vendor pays out prior to deposit (i.e. for business and personal expenses) must be added to the deposit amount to arrive at total gross receipts.

- (3) An examiner can accurately estimate gross income of mobile food vendors using relatively few examination hours. If the examiner must use an indirect method to compute gross receipts, the examiner must obtain sufficient testimony from the taxpayer in the interview. The examiner will then evaluate the credibility of the testimony and use it to corroborate the calculations.
- (4) Additionally, if the examiner uses the indirect markup method to calculate gross receipts, cost of goods sold must be reliable and accurate (see Cost of Goods Sold later). For more information on the markup method, see the discussion in Chapter 2 of this ATG and see IRM 4.10.4.6.5.

### C. Cost of Goods Sold

- (1) Mobile food vendors may not report inventories and any reported inventories may be immaterial, since food must be sold or discarded soon after purchase and there may be little space for inventory storage.
- (2) If inventory is purchased using cash, the examiner must ensure that all cost of goods sold are included. This is especially important if the examiner is using an indirect markup method to compute gross receipts, since additional cost of goods sold using a markup percentage of 100-200% will produce substantial gross receipts.
- (3) Some food truck owners are linked to specific commissaries that stock and store their trucks overnight. The commissary is a wholesale supermarket where the mobile food vendor can buy food and supplies in bulk. Most trucks assigned to a commissary are required to park their vehicles there overnight for washing, unloading, and morning loading of food.

### D. Expenses

- (1) See Chapter 2 of this ATG for a general discussion of expenses that many retailers incur. The examiner may also encounter vehicle expenses and penalties/fines expenses when examining mobile food vendors.
- (2) **Vehicle Expense** - There is little question that most mobile vendors incur some transportation expenses. Vendors often pick up both food and supply items, rather than having them shipped or delivered. The examiner should be alert for overstated business mileage deductions.
- (3) In some areas, mobile vendors use the services of strikers to wash and load trucks. These strikers work at the large catering wholesalers and may be paid in cash. As with other payees, the taxpayer must be able to identify individuals paid, provide the individual's SSN and perform the required information reporting. If these steps are not taken, it is difficult for the taxpayer to prove a bona fide business expense was paid, especially if it was paid in cash.
- (4) **Penalties, Fines, Tickets** - The examiner should be cognizant of possible penalties or fines for violations of the health code, which may be improperly deducted as a business expense. Some common health code violations include improper food temperatures, unsanitary conditions, infestations, sale of home

prepared foods, and operating without a valid health permit or business license. Costs incurred to remedy the situation, such as a repair to a heating or cooling device, are deductible business expenses. However, fines, penalties or tickets are not deductible. Examiners should consider IRC § 162(f).

## E. Glossary

- (1) **Cold Truck** - Catering trucks which sell pre-packaged food such as cold sandwiches, for example, self-service industrial catering vehicles.
- (2) **Commissary** - Wholesale supermarket where catering truck drivers purchase food in bulk.
- (3) **Fleet Operator** - Persons who own several catering trucks and hire individuals to drive their trucks.
- (4) **Hot Trucks** - Catering trucks that prepare and serve hot food such as breakfast, hamburgers, burritos, tacos, etc. For example, mobile food preparation units.

## VII. Chapter 7: Gasoline Service Stations

### A. Introduction

- (1) Gasoline service stations primarily sell gasoline and diesel fuels, along with oils/lubricants and other automotive supplies. Many service stations also sell cigarettes, snacks, beverages, and lottery tickets. In addition, some provide auto maintenance and repair services. Certain aspects of service stations' business are closely regulated or monitored by state and federal agencies that are responsible for sales tax, weights & measurements, environmental concerns, measurement standards, etc.
- (2) The service station has historically been the type of business where most of the income and many of the expenses are paid in cash. Now, customers of all retail businesses are increasingly using credit cards and are moving away from cash. However, when service stations still do a significant portion of business in cash, the normal audit trail is more difficult to follow. See the separate Cash Intensive Businesses ATG for additional guidance.

### B. Initial Interview Questions

- (1) The initial interview is an important part of any examination but is particularly important in cash-intensive businesses or those with weak internal controls. The following are some suggested interview questions for examiners to ask when examining a service station business:
  - Are other items sold or services rendered at the location(s) (e.g. any unbranded pumps, car wash, snowplows, towing services, cigarettes, beverages, vending machines, tires, repair bays, licensing for state inspections, mini-mart, lottery tickets, etc.)?

- What are your gasoline products' mark-ups per grade for the year under exam?
- Was the mark-up the same in prior years?
- What is your merchandise product mark-up for the year under exam?
- Was the mark-up the same in prior years?
- Do you have inventory on consignment (fuel, merchandise, etc.)?
- What is your hourly rate for mechanics when taxpayer provides auto body repair services?
- What is the daily gasoline sales volume? By type of gasoline? By season?
- What is the daily merchandise sales volume? By season?
- How many car repairs do you perform per day when taxpayer provides auto body repair services?
- How often do you receive a fuel or merchandise load?
- Do you accept credit card sales? What percentage is gasoline?
- Do you make many cash sales?
- Name or provide a list of all the suppliers you get gasoline or other products from.
- What is the dollar amount of beginning and ending inventory for all categories of product sold (gasoline, food, cigarettes, etc.) for the year under exam?
- Has the station been remodeled? When? How long was the station closed for remodeling? Who paid for the remodel? Did you receive any reimbursement for the remodel? Did you receive financial reimbursements such as business income replacement?
- Are you a full-service station? If so, what percentage of gasoline sales is full service?
- Do you purchase blending products such as alcohol, naphtha, and transmix?
- Do you own any delivery trucks or tow trucks? If yes, do you supply your own fuel? Who do you buy it from?
- Were you required to file a Form 720 (Excise Tax) or Form 2290 (Highway Use Tax)? Did you file it? (them)?
- Do you pay federal excise tax on all your fuel purchases? (Obtain copies of sample invoices for all fuel types. If the taxpayer purchased any fuel without paying excise tax, contact a local excise tax agent.)
- How many bulk storage tanks do you have? What is their capacity?

- How many gallons of each grade and type of fuel were in your inventory at year-end?
- Is gasoline ever sold as diesel fuel?
- How do customers use propane?
- Do you sell cars at the station?
- Does the owner of this station own any other service station(s) in whole or in part as an individual, partner, and/or shareholder?
- Did you purchase or sell any real estate during the tax year under exam? (If the taxpayer did purchase or sell real estate, request records of the transaction. The County Auditor's website for the county in which the real estate was sold or purchased is a good primary source for real estate records.)
- How many pumps do you have? What grades of product do you sell? Do you sell any other related products such as diesel fuel, propane, or blending products?
- What internal controls do you have in place? Are the internal controls currently in place the same as during the year under audit?

## **C. Income**

### **C.1. Incentive Agreements**

- (1) Incentive agreements go by many names, such as imaging reimbursement programs or rebates (both discussed later), competitive allowance, paybacks, advertising allowance or subsidies, and profit participation.
- (2) Service stations may receive incentive "awards" or agreement payments from oil companies in many fashions. Usually the oil company gives the station a discount per gallon of fuel purchased or a discount for purchases over a certain monthly volume. Or the service station may receive a lump sum payment based on total yearly sales.
- (3) Generally, a service station owner should include these lump sum payments fully in gross income in the taxable year that is proper under the station owner's overall method of accounting for tax purposes.

### **C.2. Imaging Reimbursement Payments- Income Issues**

- (1) See also Imaging Reimbursement Payments- Expense Issues under the Expenses section in this chapter.
- (2) Imaging reimbursement payments are cash or property payments made from an oil company to a service station owner for improving the image of the owner's station. The oil company may disburse cash payments in a lump sum or in a series of payments upon the purchase of petroleum products. The oil

company might also require the station owner to pay for the improvements before it disburses the cash payments.

- (3) The payments are used for signs, painting, and overall appearance improvement. This money is also issued to either change brands (re-branding) and/or to improve the general conditions of the station. The station owner often maintains title to the improvements. Improvement of the station may be contingent upon the station owner purchasing a specified volume of petroleum products.
- (4) Exam issues arise when service stations do not properly report these imaging reimbursement payments for tax purposes. Some taxpayers do not use the payments for making improvements, do not claim the payments as income, or do not report the income from the payments in the correct tax year.
- (5) Other taxpayers improperly treat these payments as a no-interest loan even though there is no expectation of repayment. Sometimes the contract reads that there is expectation of repayment but has vague repayment provisions. Thus, even when the taxpayer makes no repayment, the provisions are considered met.
- (6) The facts and circumstances of each image upgrade program are different and produce different tax results. For example, the tax results may vary depending on the relationship of the cash payments to the purchases of petroleum products, the nature and ownership of the image upgrades, or the contractual relationship between the gasoline station owner and the oil company. Service station owners should consult with a tax advisor to determine the proper tax treatment.
- (7) Generally, a service station owner should include the cash payment fully in gross income in the taxable year that is proper under the station owner's overall method of accounting for tax purposes. However, in certain cases, the payments may be considered a loan.
- (8) The Tax Court has considered certain objective facts to determine a taxpayer's intent and whether a bona fide loan occurred. The factors derived from case law and applied by the Tax Court included the following:
  - The existence or non-existence of a debt instrument;
  - Provisions for security; interest payments and fixed payment date;
  - Whether repayments of a loan were made;
  - The taxpayer's ability to repay the loan; the borrower's receipt of compensation; and the testimony of the taxpayer the repayment of loan must be unconditional and not contingent upon some future event. *Friedrich v. Commissioner*, T. C. Memo, 1989-103 aff'd, 925 F.2d 180 (7th Cir 1991). See also *Welch v. Commissioner* 204 F.3d 1228 (9th Cir.2000), *Colombo v. Commissioner*, T.C. Memo 1975-162.

- (9) In addition, most loans (for example, home loans) usually have a date certain for repayment and a defined periodic payment amount. It is not necessary to have a definite fixed monthly amount to have a valid loan if the taxpayer's loan meets the court's definition of a bona fide loan as discussed above.
- (10) After considering the bona fide loan criteria outlined above, the examiner should answer the following questions when determining whether an amount received should be considered a loan or income to the station owner:
- Was there a debtor-creditor relationship created at the time the proceeds in question were received by a party to the transaction?
  - Was there intent to repay the other party?
  - Did the creditor intend to enforce the repayment "obligation"?
  - Was the transfer documented and evidenced by written agreements? (For example, is there a note?)
  - Was interest paid?
  - Was there regular repayment of principal or interest by the debtor?
  - Was there a specific date for repayment of a sum certain by the debtor? Alternatively, was the repayment predictable and realistic?
- (11) As mentioned at the beginning of this chapter, service stations are more than dispensers of gasoline. The typical station may have one or more of the following sources of revenue:
- Gasoline
  - Diesel Fuel
  - Sale of Vehicles
  - Car Wash
  - Mini-Markets
  - Lottery
  - Check Cashing
  - Propane
  - Scales
  - Repair Shops
  - Towing
  - Kerosene
- (12) If the service station is a small, closely held or family-owned business, it may have weak or no internal controls. Sometimes the business maintains few records or keeps records sporadically and in a disorganized manner. For these

situations, there are alternative approaches to computing income in an exam, as discussed in the paragraphs to follow.

- (13) If minimum income probes and an examination of gross receipts suggest that income is underreported, or if the taxpayer's records are incomplete, the examiner may need to obtain income information from third party sources. See Chapter 2 of this ATG for more information on third party contact procedures.
- (14) The following are some potential sources of information for records pertaining to a service station's income, each of which is discussed in more detail below:
  - Oil Company
  - Food, Beverage, Cigarette Wholesalers
  - Parts Suppliers
  - State Certification & Inspection Information (for auto body repair income)
  - State Sales Tax Records
  - Public Records

### **C.3. Oil Company**

- (1) The oil company can provide records of its sales to the service station. Compute purchases and sales using records received from the oil company and compare to tax return. Remember, this is only the gasoline/diesel fuel sales and the service station may have other sources of revenue (discussed above).

### **C.4. Food, Beverage, Cigarette Wholesalers**

- (1) During the initial interview, the examiner should ask which suppliers the taxpayer uses. The food, beverage, cigarette and other suppliers usually issue invoices with not only purchases but with suggested sale prices.
- (2) Obtain copies of these invoices to determine the taxpayer's total purchases of these products during the tax year. Then use the purchase amounts and suggested sales prices from the invoices along with information obtained during the taxpayer interview (e.g. markup, sales volume) to estimate the income from sales of these other items. Note that an apparent sudden decrease in order volume from a supplier may indicate the taxpayer started using a new supplier for that product.

### **C.5. Parts Suppliers**

- (1) As with food, beverage & cigarette wholesalers, the examiner should ask which parts suppliers the taxpayer uses, if it provides auto repair services. Obtain copies of the supplier invoices to determine the taxpayer's purchases for the tax year. Using these purchase figures and information obtained during the taxpayer interview (repairs per day, mechanics' hours, etc.), estimate the income from auto repair services.



## **C.6. State Certification & Inspection Information**

- (1) A unique method of estimating service stations' income from auto repairs involves the use of smog or environmental certificate/inspection information available through certain states. For example, in California, this information is available through the California Bureau of Automotive Repairs. The state records not only show actual smog certificates issued but they also may show the repairs made to bring the car to certification level.
- (2) If state records are available for the state in which the service station is located and if the station does a considerable number of repairs for environmental certifications, the records may provide useful information for estimating income from these types of repairs

## **C.7. State Sales Tax Records**

- (1) In a state with sales tax, the examiner can reconcile gross sales amounts on the sales tax returns with related gross receipts reported on the federal return. Also see the discussion of indirect methods for computing retailers' income, discussed in Chapter 2 of this ATG.

## **C.8. Public Records**

- (1) Information for certain types of transactions is publicly available. For example, like all real estate transactions, sales of service stations go through escrow and are publicly recorded, typically with the Recorder's office in the county in which the service station is located. Many counties now have their real estate information and transactions publicly available in searchable databases online.

## **C.9. Indirect Methods**

- (1) If the examiner determines the use of a formal indirect method for computing income is appropriate, auto repair income (for service stations that provide auto repair services) can be estimated using mechanics hours and the number of service bays. Auto repair services income consists of service charges (i.e. to cover the mechanic's hourly rate) and parts charges. Although mechanics in each geographic area have a different hourly rate, the rate is usually posted at the business and the consumer is notified of it before the repair is authorized. The charges for parts also vary depending on geographic area.

### **Example**

- (2) ABC Service Station provides auto repair services using one bay and one mechanic. It charges customers \$40 per hour of labor and pays its mechanic \$20 per hour. The mechanic works 6 hours per day, 6 days a week, and the station is closed for certain major holidays. During the tax year under exam, the mechanic worked for 310 days. ABC uses a 50% mark-up on its repair parts.
- (3) First, compute profits per day as follows:

Gross Profit per Day- Labor (\$40 x 6 hours)	\$ 240.00
Mechanic's Wages (\$20 x 6 hours)	<u>120.00</u>
Net Profit per Day- Labor	120.00
Cost of Repair Parts Used per Day	\$ 100.00
Mark-Up Factor (100% cost + 50% mark-up)	<u>150%</u>
Gross Profit per Day- Parts	\$ 150.00

Then, compute profits for the year as follows:

Gross Annual Profit- Labor (\$240 daily x 310 workdays)	\$74,400.00
Gross Annual Profit- Parts (\$150 daily x 310 workdays)	<u>46,500.00</u>
Total Gross Annual Profit from Auto Repairs	\$120,900.00

- (4) Note: This example is for one mechanic/bay; usually there is more than one mechanic and one bay per station. If a station owner shows the examiner a repair bay operating at grossly less than the wages of its mechanic, there is reason to investigate further.
- (5) For detailed information on the use and types of formal indirect methods for computing income in an examination, see Chapter 2.

### C.10. Other Exam Issues- Omitted Income

- (1) There have been cases where owners of multiple service stations file a tax return with income and expenses from some of their stations but without omit the income and expenses from one or more other stations. When issuing an IDR or serving a summons, request information for "this station and any other stations, owned or operated by (the taxpayer)."
- (2) Review purchase orders from vendors and suppliers carefully, whether provided by the taxpayer or through a third-party request to the vendor. Look for deliveries to different addresses, a sudden unexplained increase in order volume, and other clues that the taxpayer owns more than one station.

### C.11. Surveys

- (1) In the absence of reliable records, examiners can use surveys to estimate income. See discussion of In-Depth Examinations of Income in Chapter 2 of this ATG. The following surveys provide potentially useful data for service station income and are discussed in more detail in the paragraphs below:
  - Bureau of Labor Statistics (BLS)
  - American Automobile Association (AAA)
  - Lundberg Survey
- (2) Bureau of Labor Statistics (BLS)

- (3) This is a Government Indexes and Databases survey covering approximately 82 markets throughout the United States. It does not compile data by Oil Company but instead compiles data by type of gasoline/diesel fuel. This survey has been successfully used in court. *Stafford v. Commissioner* T.C. Memo 1992-637.
- (4) While BLS statistics can be used to support an income adjustment, such statistics may not be used solely to determine income. IRC § 7491(b).
- (5) American Automobile Association (AAA)
- (6) AAA canvases the United States. There has not been a court case using this survey. Area Counsel should review AAA survey before it can be used in an exam. AAA provides in its AAA Daily Fuel Gauge Report, comprehensive retail gasoline surveys, based on daily data taking in over 60,000 self-serve stations.
- (7) Lundberg Survey
- (8) The Lundberg Survey provides retail selling prices for gasoline and diesel fuel. The prices are listed by various different classifications, including type of oil company, full-service stations, self-service stations, credit purchases, cash purchases, and grade of gasoline. The use of this data source was upheld in *Barragan v. Commissioner*, TC Memo 1993-92, aff'd 76 A.F.T.R.2d 95-5629, 95-2 U.S.T.C. 50,624 (9th Cir,1995) *Diesel Country Truck Stop, Inc. v. Commissioner*. T.C. Memo. 2000-317

## **D. Cost of Goods Sold**

- (1) The following are several potential cost of goods sold-related issues pertaining specifically to service stations and are discussed in more detail in the following paragraphs:
  - Shrinkage, Leakage, Theft, and Personal Use
  - Service Station Acquisition Payments
  - Liquidation/Accommodation Agreements, Security Agreements, Prepayment/Reserve Account Deposits
  - Rebates
  - Excise and Sales Taxes

### **D.1. Shrinkage, Leakage, Theft, and Personal Use**

- (1) The service station may claim shrinkage, leakage, theft or personal use as reasons for a material discrepancy in cost of goods sold. However, there is typically minimal loss or use of fuel for these reasons. If the station claims large amounts of fuel was lost through shrinkage, leakage or theft or that the station owner used large amounts of fuel for personal purposes, it should be able to substantiate these claims. For example, if there was substantial leakage, the local environmental agencies or fire department would have been involved, and the station would have documentation of the cleanup.

## **D.2. Service Station Acquisition Payments**

- (1) One potential cost of goods sold issue unique to service stations relates to service station purchases. If the taxpayer purchased a new service station during the tax year, the examiner should discuss the details of the purchase during the initial interview and should obtain copies of the purchase agreement.
- (2) Many oil companies offer agreements that allow new owners to purchase the assets of a service station over time. In these agreements, the new owner pays off the liability by paying an extra few cents for each gallon of fuel purchased from the oil company. This extra charge is a combination of principal and interest paid for the assets and should not be charged to cost of goods sold as purchases. Rather, the principal should be charged against a payable and the interest should be recorded as an expense item.
- (3) The examiner should consider the impact of the sale of franchise rights and franchise agreements/lease versus sales.

## **D.3. Liquidation/Accommodation Agreements, Security Agreements, Prepayment/Reserve Account Deposits**

- (1) Sometimes the service station pays a one or two cent additional per-gallon charge that appears on the purchase invoice from the oil company. The money the station pays for this extra charge is placed in an account, which is like a savings account and is used for the discretionary benefit of the service station. Disbursement of funds from the account may go directly to the station or to third parties on the station's behalf, and the station may earn interest on the account balance.
- (2) The account appears on gasoline purchase invoices, but this extra per-gallon charge should not be charged to cost of goods sold as purchases. The examiner should review the purchase invoices to make sure that the total purchase amount does not include the amount paid into the reserve account. If the invoice total does include the amount paid into the reserve account, the examiner should make sure that the taxpayer is not deducting the amounts paid into the account. Additionally, the examiner should ensure that the taxpayer has included as income any interest earned on this account.

## **D.4. Rebates**

- (1) Major oil companies offer incentive programs which give rebates for increased purchases. For example, the oil company may pay a rebate for a station to be shut down for remodeling or for replacement of the underground storage tanks. Some oil companies give rebate incentives for stations being open 24 hours. Generally, rebates must be offset against the purchase price of the merchandise on which rebates are computed.
- (2) The most common rebate is for a new owner of a station or for an owner who has remodeled a station. This rebate is frequently a few cents per gallon and is applied to the volume increase resulting from the new or remodeled station. The

oil company generally applies this rebate against the station rent or as a credit to the taxpayer's account.

- (3) The examiner should review supporting documentation for the rebates to ensure the taxpayer does not deduct the full fuel purchase amount through cost of goods sold without reducing it by the related rebates. See Treas. Reg. § 1.471-3(b).
- (4) A change to correct the timing of when a taxpayer accounts for purchase rebates (for example, income versus reduction of the price of purchased merchandise) is a change to the taxpayer's method of accounting to which the provisions of IRC §§ 446 and 481 apply. See Rev. Proc. 97-27, 1997-1 C.B. 680.

## **D.5. Excise and Sales Taxes**

- (1) Federal excise taxes on gasoline, diesel fuel, and kerosene, are imposed on the products before the products are delivered to the service station. Thus, the service stations are not responsible for paying these taxes to the government. Rather, the taxes are usually included in the station's purchase price of the products. (See the discussion of "Blending" under Excise Tax Issues later in this chapter). Similarly, oil companies collect sales tax from the service station. The station then receives credit for this pre-collected sales tax on its state sales tax returns. When the station sells fuel, it collects sales & excise taxes from the end consumer.
- (2) The examiner should review purchase invoices to determine whether total purchases per the invoice includes excise and/or sales taxes. One common problem found during exams involves mismatching of sales/excise tax collected from customers and sales/excise tax paid on purchases. If the taxpayer reports gross receipts net of sales & excise taxes collected from customers, it should also report purchases net of sales & excise taxes paid to the oil company. However, when BLS surveys are used for estimating income, taxes paid should be included in purchases because the retail selling price in the BLS survey includes all appropriate taxes.

## **E. Expenses**

### **E.1. Rent Expense**

- (1) Most major oil companies charge service station rent based on gallons of fuel purchased, then give the service station owner a rent rebate. Purchase invoices from the oil company typically show total rent without considering the rent rebate. Examiners should carefully review the supporting documentation to ensure the taxpayer is only deducting rents net of the rent rebate.

### **E.2. Imaging Reimbursement Payments- Expense Issues**

- (1) As discussed earlier in this chapter under Imaging Reimbursement Payments- Income Issues, imaging reimbursement payments are cash or property payments made from an oil company to a service station owner for improving

the image of the owner's station. The payments are used for signs, painting, and overall appearance improvement. This money is also issued to either change brands (re-branding) and/or to improve the general conditions of the station. The station owner often maintains title to the improvements. Improvement of the station may be contingent upon the station owner purchasing a specified volume of petroleum products.

- (2) Multiple issues may arise with respect to costs incurred under an imaging reimbursement program. For example, the taxpayer may improperly capitalize improvement costs for assets it doesn't ultimately own and then deduct the related depreciation. Reimbursement payments often exceed actual improvement costs, and sometimes taxpayers improperly capitalize the total amount of the payments (rather than the costs), which results in too much depreciation expensed over the life of the assets. In still other cases, taxpayers may improperly deduct or capitalize the cost the improvements without claiming the payments received as income.
- (3) A station owner can deduct certain costs paid with monies received under an imaging reimbursement program. To be deductible, these costs must be for ordinary and necessary expenses paid or incurred in the taxable year for carrying on a trade or business. Deductible costs may include incidental repairs and advertising.
- (4) A station owner cannot deduct any costs paid or incurred for new buildings or permanent improvements or betterments that increase the value or prolong the useful life of property. Instead, these costs must be treated as capital expenditures. For example, expenditures for new signage and new gasoline pump must be capitalized. Generally, such capitalized costs may be recovered through depreciation or amortization. Any remaining basis is considered in determining gain or loss when the property is sold or otherwise disposed of.
- (5) In the first year in which a taxpayer begins to capitalize costs required to be capitalized, which the taxpayer has consistently deducted in the past, there is a change in the taxpayer's method of accounting to which the provisions of IRC §§ 446 and 481 apply.

### **E.3. Environmental Clean-Up Costs**

- (1) Rev. Rul. 94-38, 1994-1 C.B. 35, generally provides that costs incurred to clean up land and treat groundwater that a taxpayer contaminated with hazardous waste from its own business are deductible by a taxpayer as ordinary and necessary business expenses under IRC § 162. However, such costs do not include costs attributable to construction of buildings, machinery and equipment having a useful life substantially beyond the taxable year (as determined under IRC § 263 and the regulations thereunder). These costs are nondeductible capital expenditures under IRC § 263.

- (2) Rev. Rul. 94-38 does not apply in situations where a taxpayer cleans up land that was contaminated prior to its acquisition. In those situations, general principles of capitalization under IRC § 263 are controlling.
- (3) Moreover, neither IRC § 162 nor § 263 applies when the costs incurred are reimbursable. Therefore, where there is a reasonable expectation of reimbursement, costs incurred for environmental cleanup may not be capitalized or deducted.
- (4) See the following examples of the treatment of various environmental clean-up activities in the Tangible Property Regulations (effective January 2014):
  - Treas. Reg. §1.263(a)-3(j)(3), Example 1- Leaking underground storage tank at acquired property
  - Treas. Reg. §1.263(a)-3(j)(3), Example 2- Asbestos remediation in building
  - Treas. Reg. §1.263(a)-3(l)(3), Example 4- Remediation of contaminated soil prior to land development
  - Treas. Reg. §1.263(a)-3(k)(7), Example 12- Underground storage tank replacement and other improvements at retail gas station

#### **E.4. Fixed Asset & Depreciation Issues**

- (1) IRC § 168(e)(3)(E) specifically includes as 15-year property “any IRC § 1250 property which is a retail motor fuels outlet (whether or not food or other convenience items are sold at the outlet).” IRC 1250 property placed in service on or after August 20, 1996, will qualify as a retail motor fuel outlet (whether or not food or other convenience items are sold at the outlets) if any one of the following tests is met:
  - 50 percent or more of the gross revenues generated from the property are derived from petroleum sales, or
  - 50 percent or more of the floor space in the property is devoted to petroleum marketing sales (not including floor space devoted to related services, such as oil changes, and floor space devoted to nonpetroleum products, such as tires and oil filters), or
  - The property is 1400 square feet or less.
- (2) Gross revenue is generally defined as the revenue generated by the sale of the product to the consumer. For purposes of determining whether a service station building qualifies as a retail motor fuels outlet, gross revenue includes all excise and sales taxes. Gross revenue attributable to petroleum sales (gasoline and oil sales, not including gross revenue from related services, such as the labor cost of oil changes, and gross revenue from the sale of non-petroleum products, such as tires and oil filters) should be compared to gross revenue from all other sources (e.g., food items, beverages, lottery, cigarettes, etc.). The gross revenue should be analyzed for a full tax period. Temporary fluctuations, such

as a special promotions, should not be included in the gross revenue test. See Chief Counsel Advisory IRS CCA 201123001 June 10, 2011; and Chief Counsel Advisory, IRS CCA 201509029, February 27, 2015.

- (3) See IRS Publication 946, How to Depreciate Property for more information, including a table of asset lives and recovery periods. Also see the Cost Segregation Audit Technique Guide, which contains specific guidance for the retail industry including property type (section 1245 or section 1250) and useful life for various types of assets. Finally, for additional information on depreciation issues in general, see the Depreciation and Cost Recovery book on the Deductible and Capital Expenditures shelf within the Corporate/Business Issues & Credits Knowledge Base in the Servicewide Virtual Library.

## **E.5. Bonus Depreciation**

- (1) The Tax Cuts and Jobs Act, P.L. 115-97 (December 22, 2017) generally increased bonus depreciation to 100% for qualified property acquired and placed in service after September 27, 2017. Please refer to the Cost Segregation Audit Techniques Guide, Chapter 6.8, for an update on the TCJA bonus depreciation rules.

## **F. Excise Tax Issues**

- (1) For more information on applicable excise tax issues, see Publication 510, Excise Taxes (Including Fuel Tax Credits and Refunds).

### **F.1. Dyed Fuel**

- (1) Diesel fuels and kerosene that has been dyed red is not taxed prior to when the fuel is delivered to the service station. The station must post a legible and conspicuous Notice stating either “DYED DIESEL FUEL, NONTAXABLE USE ONLY, PENALTY FOR TAXABLE USE” or “DYED KEROSENE, NONTAXABLE USE ONLY, PENALTY FOR TAXABLE USE” on any retail pump where it sells dyed diesel fuel or dyed kerosene. A substantial penalty and tax may be imposed on a service station that sells dyed fuel for a taxable purpose, such as for use in a registered highway vehicle. If the examiner suspects that these rules are being violated, contact the excise tax group immediately.

### **F.2. Blending**

- (1) Some service stations sell gasoline and diesel fuel into which the operator has added previously untaxed liquid. This practice is called blending. Stations may blend to generate more sales per gallon of gasoline or diesel fuel purchased. The most common products used for blending include naphtha, alcohol, transmix, and waste oil. Generally, the service station owes excise tax on this increased volume of fuel since it came from previously untaxed liquids.
  - If the examiner suspects that a service station is not paying the proper amount of excise tax on its blended fuels, the examiner should contact the excise tax group immediately. If the examiner finds an invoice for one of



these blending products, issue an IDR or serve a summons for invoices showing all blending product purchases. When BLS surveys are used for estimating income, add total blending product purchases to the original gasoline and diesel fuel purchases before applying the BLS pricing.

## G. Useful Websites

- (1) The following are some useful websites for examiners with service station exams:
  - Society of Independent Gasoline Marketers of America (SIGMA)
  - The Petroleum Marketers Association of America (PMAA)

## H. Glossary

- (1) **AGO** (Atmospheric Gasoline Oil) - a volatile distillate.
- (2) **Back-Up Tax** - a per-gallon excise tax imposed on dyed diesel fuel that is sold or used for other than a nontaxable purpose. (In addition to penalty)
- (3) **Cetane Number** - a measure of the ability of a fuel to ignite spontaneously, desirable in the operation of a diesel fuel engine.
- (4) **Cloud Point and Count Point** - the temperatures at which wax crystals form and clog the fuel-injection system of a diesel fuel engine.
- (5) **Distillate** - a refined petroleum product produced by the distillation of crude oil.
- (6) **Dyed Diesel Fuel** - regulations specify dye concentration. Notice of dyeing is required on paperwork by terminal operators and distributors, and on retail pumps where dyed diesel fuel is sold. A penalty is imposed for selling or using dyed diesel fuel for a taxable use or for altering dyed diesel fuel.
- (7) **Excise Tax Agent** - audits excise tax returns and imposes back-up tax. All potential excise tax issues should be referred to the Excise Tax Group.
- (8) **Form 637 Application for Registration (For Certain Excise Tax Activities –** registration form for diesel fuel producers, refiners, importers, terminal operators, blenders, through putters, compounders and others, such as those selling or buying taxable items tax-free.
- (9) **Form 720 Quarterly Federal Excise Tax Return** - used to report and pay excise taxes.
- (10) **Form 2290 Heavy Highway Vehicle Use Tax Return** - used to compute and pay the use tax due on heavy vehicles (over 55,000 pounds) used on public highways. May apply to service stations with tow trucks, for example. It is also used to claim exemption from the tax when such vehicles are expected to be used on public highways 5,000 miles or less (7,500 miles or less for agricultural vehicles). Proof of payment of this tax is required to register a heavy vehicle in any state.

- (11)**#1 Diesel Fuel** - a volatile distillate fuel used in high speed diesel fuel engines operated under wide variations of speed and load, such as city buses.
- (12)**#1 Fuel Oil** - a light distillate used in vaporizing-type burners.
- (13)**#2 Diesel Fuel** - a lower volatility oil for use in high-speed diesel fuel engines operated generally under uniform speed and load conditions, such as railroad engines and highway roads.
- (14)**#2 Fuel Oil** - a distillate used in atomizing type burners for home and other moderate size heating applications.
- (15)**#4 Diesel Fuel** - used in low speed diesel fuel engines.
- (16)**#4 Fuel Oil** - a blend of distillate and residual fuel oil used for commercial burners in larger size heating applications, such as industrial plants.
- (17)**Kerosene** - similar to #1 fuel oil with specifications that improve it for use in space heaters, cook stoves and lamps.
- (18)**MDO (marine diesel fuel oil)** - a volatile distillate used specifically for marine/ship purposes.
- (19)**Naptha /Alcohol** - used to mix with diesel fuel and gasoline. Naphtha has no real purpose outside of blending with other products., while alcohol can be legally blended up to 10% and sold as gasoline.
- (20)**Non-Taxable Uses** – for excise tax purposes, there are multiple non-taxable uses of fuel, including 1) Use on a farm for farming purposes; 2) Exclusive use of state or local government; 3) Use other than as fuel in the propulsion engine of a highway vehicle, boat, or train; and 4) other limited uses. See Publication 510, Chapter 2 for more details.
- (21)**Rack** - a mechanism for delivering fuel from a refinery or terminal into a truck, trailer, railroad car, or other means of non-bulk transfer.
- (22)**Residual Fuel Oil** - a heavy oil that remains after distillation which is used for electric power generation, space heating, ship bunkering and various industrial applications. Includes #5 and #6 fuel oils.
- (23)**Taxable Event** – there are multiple types of taxable events for excise tax purposes, including removal from terminal rack, entry into the United States, or removal or sale of blended diesel fuel.
- (24)**Transmix** - the portion of products mixed in transport, that is, diesel fuel is mixed with gasoline while in transit.

## VIII. Chapter 8: Motor Vehicle Dealerships

### A. Introduction

- (1) Motor vehicle dealerships sell and service all types of motorized vehicles, including cars, trucks, buses, recreational vehicles, and heavy equipment. The

industry is composed of two major segments—new vehicle dealerships and independent dealerships.

- (2) New vehicle dealerships are affiliated with major vehicle manufacturers. They sell new and used vehicles outright; accept trade-in vehicles in exchange for new and used vehicles; and purchase used vehicles directly from customers, other dealers, and wholesale auctions.
- (3) Independent vehicle dealers are not affiliated with major vehicle manufacturers. Typically, their principal business is the sale of used vehicles, which they acquire from customer trade-ins or by purchase from individuals, other dealers, and wholesale or retail auctions. Independent dealerships range in size from small “mom and pop” operations to large, multi-location public corporations. The size of the dealership and the capital required to enter the industry varies and sophistication of operations and availability of records increases with the size of the dealership.

### **A.1. Impact of state regulation and state law**

- (1) Every state regulates the operations of motor vehicle dealers and regulations vary from state to state.
- (2) Common dealership activities regulated by states include the following:
  - Transfers, assignments, and reassignments of titles
  - Collection and repossession rights and liabilities
  - Consignment rules and procedures
  - Payments of commissions for referring buyers
- (3) Obtain additional information on state laws from the applicable state Motor Vehicle Division.

## **B. Records**

- (1) The sophistication of the accounting and records system (including record retention) will vary with the dealer's size and location. However, there are certain common industry practices that provide documentation for a sales transaction.

### **B.1. Car Jacket**

- (1) The key record of a car sale is the car jacket, customer file, or deal jacket, normally maintained separately for each sale. Many dealers create a car jacket whenever a customer purchases a vehicle and assign a stock number to the vehicle. Use the car jacket to track the cost of the vehicle and the cost of reconditioning the vehicle for sale.
- (2) The file generally contains:
  - Cash Sale (No Trade-in)

- Retail buyer 's order (including the VIN),
  - Buyer's name, address and other information,
  - Sales price,
  - Sales tax (depending on the state, sales tax may be on the gross sales price or net sales price),
  - Documentary and Filing (Doc) fees,
  - State and Federal Disclosure statements, including odometer readings,
  - Vehicle stock number,
  - Extended warranty or service contract information and information on any insurance purchased,
  - Form 8300 Report of Cash Payments Over \$10,000 Received in a Trade or Business, if applicable.
  - Sales with Trade-ins
  - Same items as for a cash sale, and
  - Payoff on any outstanding loans, if applicable,
  - Actual Cash Value (ACV) of trade-in.
- (3) The customer file may be a separate manila folder, an envelope with the information in it, or simply papers stapled together. All are acceptable methods of record retention.

## **B.2. Cash Receipts**

- (1) A dealer will normally maintain cash receipts records that will show the cash received by the dealer on a daily basis. An analysis of the deposits will indicate the sources of the dealer's revenues, which could include:
- Auto sales
  - Collections on self-financed sales
  - Commissions from service/warranty contracts sold
  - Commissions from disability and life insurance contracts sold
  - Income from bank financing
  - Customer paid service work

## **B.3. Accounting records**

- (1) The industry custom is to maintain a file of cars in inventory by stock numbers. The dealership assigns a stock number at the purchase of each car and records the stock number of the car in the customer file at the time of sale. The dealer will note other dispositions of the cars, for scrap, at auction, etc.

## **B.4. Accounts receivable**

- (1) New car dealerships have very detailed receivables and separate schedules for each receivable type. An independent used car dealership may have no detailed receivable information. Some used car dealers do not maintain accounts receivable since the dealership only accepts cash on delivery of the vehicle
- (2) Others may allow selected buyers to pay a portion of the purchase on delivery and accept payments for the rest. Gross receipts may not show the full amount when the sale is made, recording the sales as the payments are received. The balance due may be kept in a separate book, index cards, or recorded on the deal-sheets. IRC § 453(l) does not permit the deferral of income from an installment sale for a dealership that regularly sells or otherwise disposes of personal property.

## **B.5. Examiners insure the reporting of all sales within the proper tax years.**

- (1) For example, examiner may sample deal sheets, checking for terms of the sale. Review sales recorded in the opening days of the next tax year to determine whether sales are includible in the proper year. Analyze the records to determine recording of the full amount of the sales price involving payment plans as income at the time of the sale.

## **B.6. Titling Issues and Processes**

- (1) State law governs titling procedures; allowing for 50 different sets of rules that apply. The state Division of Motor Vehicles, or similar agency, regulates the issuance and transfer of a vehicle title and maintains a record of the owner. This information is available, although its usefulness in tracking an unreported sale or sales will depend on the database used by that state.
- (2) In most states, dealer reassignments permit dealer-to-dealer transfers of title. The taxpayer does not usually record reassignments with the state unless the state issued the original title or is recording the title once the taxpayer ultimately sells the vehicle to a retail customer.
- (3) Although the use of state title transfers does have drawbacks and cannot be used to reconstruct or determine all a dealer's sales, it remains a useful tool in checking the accuracy of reported sales.
- (4) Despite no uniformity in titling rules or procedures, some very basic elements exist in all states:
  - Every vehicle must have a title,
  - A written record of the sales transaction given to a customer,
  - Produce a valid title regarding a sale, but some exceptions exist for old vehicles in some states,

- Only dealers can reassign title, individuals cannot reassign titles.
  - Generally, title reassignment for vehicles purchased at an auction is directly from the seller to the buyer, although some states require the auction to note on the reassignment of title that the transaction is an auction sale.
- (5) In most states, dealers need not take actual title to a vehicle, but can reassign the title. Look for the possible notification of a transfer on the title or on a separate sheet attached to the title. The significance of reassignment is that the dealer will not have to register the title with the Motor Vehicle Division until the vehicle is sold "at retail" to a non-dealer customer. This can make tracking the sale of a vehicle very difficult.

### **Example of Titling**

- (6) A dealer in Virginia takes a vehicle with a Maryland title in trade on a sale. The dealer then sells the trade-in at a North Carolina auction, assigning title to the North Carolina dealer that acquires the vehicle. That dealer then sells the vehicle to a Florida dealer with a reassignment of title.
- (7) The Florida dealer then sells the vehicle to a New York dealer, again reassigning the title. Finally, the New York dealer sells the vehicle to a California dealer, by yet another title reassignment. The California dealer then sells the vehicle to a California resident. The State of California will issue the new title to the retail purchaser. California may notify Maryland, the state with record of the original title, of the new title. Maryland would then cancel the original title.
- (8) The notice may show all the reassignments. However, no title record of the vehicle's sales will appear in any of the intervening states. The Virginia, North Carolina, Florida, and New York Motor Vehicle Divisions will not record the vehicle's sale in their state. However, each dealer should have a deal jacket for the transaction involving the vehicle.

## **C. Initial Interview**

- (1) The initial interview is crucial in all examinations. When examining an independent used vehicle dealer, the standard interview questions are required. In addition, industry specific questions should be included. For example:

### **C.1. Income Sources:**

- What types of sales transactions did the dealership have for the year under examination?
- Sales at auctions? If yes, which auctions? Identify any out of state auctions?
- Sales to wholesalers? If yes, which wholesalers? Identify any out of state wholesalers?

- Sales to other dealers? If yes, which dealers?
- Consignment sales? If yes, what was the volume?
- Where there any scrap sales? If yes, inspect the details.
- Did the dealership engage in any in-house financing of vehicle sales?
- Identify any in-house financing notes sold to a third party.
- Request a description and flow chart of financing operations.
- Describe and provide examples vehicles financing with the third-party finance company, including related and unrelated finance companies. If a related finance company (RFC) is involved, determine ownership and consider whether transactions with the RFC are at arms-length.
- How did the dealership account for interest earned on dealer-financed sales?
- Did the dealership receive commissions or referral fees on third-party financing? If so, review the accounting.
- Did the dealership sell insurance products? If so, what types?
- Did the dealership earn commissions or referral fees on vehicle insurance placement? If so, review the accounting?
- Identify any insurance companies used?
- What was the fee/commission arrangement?
- Did the dealership sell extended warranty, service, or maintenance contracts? If so, what types and from what companies?
- Request a detailed description, sample copies of all products sold, and a flow chart including initial sale to the customer and all subsequent transactions.
- Are there other income sources? If so, describe.

## **C.2. Sales**

- Request a detailed description and flow chart illustrating a typical sales transaction.
- Request and review sample sales contracts and deal jackets
- Are sales taxes reported in the gross sales price?
- Are licensing fees or titling fees included in the sales price? (Note; if answer is no, look for them as expense items?)
- If you assign a value to a trade in vehicle that is over market value to make a sale of a vehicle to a customer, how do you record it on the books? How do you record this paper loss?

### C.3. Inventory Items

- When setting an initial inventory value for a vehicle, what information sources are used? If a used vehicle guide is used, which one? Are any other guides used? If so, what is their purpose?
- If you assign a value to a trade in vehicle that is over market value to make a sale of a vehicle to a customer, how do you record it on the books?
- Is the inventory value ever changed? If so, the reasoning for such a change? How reported for the books?
- Are there inventory write-downs at year-end? If so, explain the process and any guides used to determine the write down. How recorded on the books? Have the dealer provide an example.
- Are any vehicles valued below cost? If so, reasoning for such valuation?
- For any vehicle that is valued below cost, how does the asking price at any point in time differ from the value recorded on the books at year-end? Please explain.
- Are repairs typically made to previously acquired vehicles? If so, how is this recorded on the books?
- Is inventory valued using LIFO, Lower of Cost or Market, Cost? If LIFO, is Alternative LIFO used? Is 263A UNICAP costing properly applied? Request inventory records and computations.
- Are items other than vehicles taken in trade? Request explanation and examples. How was it accounted for on the books?
- Request the log/record of titles for all vehicles sold for the year.
- Are vehicles acquired at auctions? If yes, specify which auctions? Which auctions, if any, are out of state?
- Are vehicles acquired from wholesalers? If yes and a few are used, which wholesalers are used? If yes, and many are used, who are the primary wholesalers? Any out of town?

### D. Overall Accounting Method

- (1) Used car dealerships normally maintain an inventory, which is a material income-producing item. The taxpayer must account for material income producing items under an accrual method of accounting. Some used car dealerships may be using an improper accounting method, either the cash method or the installment method. IRC § 448 places limits on the use of the cash method of accounting. IRC § 453(b)(2)(A) and (B) disallow the use of installment method on any dealer disposition and disposition of personal



property that would have to be included in inventory if the property were on hand at the close of the taxable year.

- (2) *Smith v. Commissioner*, T. C. Memo. 1983-472. The court ruled that where the purchase and sale of automobiles was the principal income-producing factor in a used car dealer's business, requiring the use of an inventory, the dealer was required to use the accrual method of accounting.
- (3) If the taxpayer is using an impermissible method of accounting, generally a taxpayer must file a Form 3115 to change to a permissible method. See Rev. Proc. 2015-13. If an examiner changes a taxpayer's method of accounting, Rev. Proc. 2002-18 provides procedures. Also, see the books on the Methods of Accounting and Timing shelf within the Corporate/Business Issues & Credits Knowledge Base in the Servicewide Virtual Library.

## **E. Potential Income Reporting Issues**

### **E.1. Trade-ins not recorded**

- (1) A dealer may not record a trade-in on a sale, and then sell the trade-in for cash. For example, a dealer may take a car in as a trade from customer A. Customer A signs the title, but the dealer does not put the car in inventory or show it on the deal sheet as a trade-in. The dealer then sells the car to customer B for cash and signs the title over to the customer. The dealer keeps the cash and the title shows a direct sale from customer A to customer B. There is no indication that the dealer was ever involved in the trade.
- (2) Indications that this may be occurring include unidentified cash deposits, reconditioning costs incurred about the same time as the sale of the trade-in, but not allocated to vehicles, substantial sales discounts, or sales contracts that show a trade-in allowance with no corresponding stock number assignment.

### **E.2. Reporting net sales based on financing obtained, omitting cash received.**

- (1) Comparing the sales contracts with the financing files should disclose this problem. In addition, use the state sales tax reporting to determine the sales price, which should include any cash paid by the customer.

### **E.3. All purchased vehicles not recorded**

- (1) Comparing the purchase of vehicles acquired by trade and at auctions to a subsequent sale of that vehicle can provide information on accuracy of sales figures. In addition, a review of claimed travel expenses can lead to information about auctions attended where possible purchases or sales occurred. However, dealers may attend auctions where they make no purchases or sales.

### **E.4. Improper allocation of purchase price to a group of vehicles**

- (1) When purchasing a group of vehicles, dealers may allocate the entire purchase price to only some of the units; then selling one or more units off the books.

Examiners should review the purchase documents to determine the number of cars purchased and analyze the cost assigned to each of the vehicles for reasonableness. The dealer generally bases the purchase price allocation on the relative value of each vehicle in the group.

#### **E.5. “Clunker” cars acquired as part of a package**

- (1) Dealer may purchase a “clunker car” as part of a package deal. The dealer may know this at the time of purchase and assign a low market value to the inventory value of the vehicle. At other times, a dealer will not realize the vehicle is a "clunker" until reconditioning has begun. At this point in time, the dealer has two likely options: (1) sell the car from his or her lot, or (2) sell the car at an auction. Either way, the likely result will be a loss on the sale of the vehicle.

#### **E.6. Unusual trade-ins**

- (1) Frequently an independent used car dealer will take unusual items including boats, trailers, snowmobiles, campers, etc. These traded items may or may not end up on the lot for sale. The owner of the dealership may be getting personal use of these items and sell them on the side as personal property instead of inventory.

#### **E.7. Bartering clubs**

- (1) In some parts of the country, used car dealers may be members of bartering clubs. For example, a dealer may receive "points" from a bartering club based on the value of a car, exchangeable for services or goods, which may be business or personal in nature. Such activities are frequently not included as income and may represent distributions to the owners if exchanged for personal goods or services, or an issue of timing of income or expense if business related the taxpayer receives goods or services.

#### **E.8. Alternate sources of information on income**

- (1) Some State Departments of Transportation/Motor Vehicle require all car dealers to maintain a record book of all used cars purchased and sold. Use of this log will not only help in determining inventory and cost of goods sold, but also in verifying all items are included in gross receipts.
- (2) In some states, the number of dealer plates issued by the state is based on gross receipts. Some other states issue plates based on the number of sales representatives or units sold. If the audit location state is one, in which the number of plates a dealer has is dependent on gross receipts, that number can give the examiner an idea of the accuracy of the amount on the return.

### **F. Income from Vehicle Sales**

- (1) Used vehicle sales are the principal source of income of a dealer and are generally made to three broad groups. First, the bulk of the income will be from the sale of a single vehicle to an individual buyer. The dealer may also have

income from direct sales to other dealers or wholesalers and from the sale of vehicles at wholesale or retail auctions.

- (2) Proceeds from the sale of a vehicle to an individual buyer may be paid in full and in cash directly from the buyer. Some dealers self-finance the sale and allow the buyer to pay weekly, bi-weekly, or monthly. Those payments may be in cash, check, money order, or by other means. Finally, payment received from a bank, finance company, or other organization that has agreed to finance the buyer's purchase of the vehicle.
- (3) Generally, sales proceeds from an auction paid to the dealer by check are marked "deposit only" or "deposit only to the account of payee." Payments from sales to other dealers can be in cash, by check or from the proceeds of loans made by a third party.
- (4) In all cases, if a dealer receives more than \$10,000 in cash, the dealer will be required to file Form 8300, Report of Cash Payments over \$10,000 Received in a Trade or Business.
- (5) In sales to an individual buyer, the ultimate determination of the sales price will depend on many factors. The initial "sales price" (asking or list price) established by the dealer is rarely the final sales price. The difference is a discount allowed to the buyer. However, that discount will not be determined the same way for each buyer because different needs and desires motivate each buyer. Some buyers want a large discount and accept the dealer's valuation of the trade-in; others want a large trade-in allowance (which in effect reduces the discount the dealer is willing to give) and still others only worry about the monthly payment. Since the dealer is interested in the bottom line profit on the sale of the vehicle, the sales price on substantially similar vehicles may differ greatly.
- (6) For example, an individual who is willing to accept the actual cash value (ACV), for his or her trade-in may have a lower sales price (or greater discount) than an individual who insists on a trade allowance greater than the trade-in's ACV, as illustrated by the following.

**Example of an automobile sale:**

- (7) A dealer wants a gross profit of \$500 each on two identical vehicles, each with a cost basis of \$3,000. The asking price of each vehicle is \$3,900 before any discounts.
- (8) Customer #1 has negotiated final sales price of \$3,500, with a \$2,000 cash payment and a trade-in allowance of \$1,500 that is the ACV of the vehicle traded in. The sales contract may show the net price of \$3,500 (\$2,000 +\$1,500) or the gross price of \$3,900, less a discount of \$400.
- (9) Customer #2 has a trade-in with an ACV of \$1,500, but refuses to accept anything less than \$1,750 for his trade-in. Customer #2 also makes a \$2,000 cash payment. The final net sales price for customer #2 will be \$3,750 (\$2,000

+ \$1,750) to consider the \$250 over-allowance (the excess trade-in allowance over the vehicle's fair market value).

- (10) In each of these cases, the gross profit is \$500; however, the sales price and trade allowances are different. In both cases, the cost of the trade-in for inventory purposes is \$1,500.
- (11) The proper accounting entry to record a sale with a trade-in is as follows using the gross sales price (using the example above):

Account	CUSTOMER 1		CUSTOMER 2	
	DR	CR	DR	CR
Cash	\$2000		\$2,000	
Discount	\$400		\$150	
Over allowance			\$250	
Inventory	\$1500		\$1500	
Sales		\$3,900		\$3,900

- (12) Notice that the only difference between these two transactions is that for Customer #1, the dealer combined the over allowance and discount into one account, rather than maintain separate accounts for each type of discount.
- (13) A dealer may account for the sale as a net sale, in which case the dealer nets the discount and over allowance against the sales price, and the net figure recorded as the sales price.
- (14) While most of a used car dealership's income is from the sale of cars, not all car sales are retail sales. Dealers may sell to other dealers, often in package deals. Dealers may also sell vehicles at various auctions; both wholesale (dealers only) and retail (public) auctions.
- (15) Used car dealerships may also provide other income-producing services or products. These services include body repair work and routine maintenance such as oil changes and tune-ups. Dealerships may also offer vehicle leasing directly to customers rather than through the manufacturer's program.
- (16) Dealers may scrap or junk purchased vehicles. The dealer may use working parts from the vehicle to recondition other cars sold to customers. A dealer may also buy cars that are already scrap cars (also called junked cars) for parts to recondition cars for sale to customers. It is possible the parts taken from a junked car can recondition several cars (for example, the carburetor used for one car, the alternator for another). Add proportionate cost of the parts used to the inventoried cost of the car sold. Once the usable parts have been removed, the junked car is normally sold to a scrap or junkyard for a small fee. The

income received for the scrap or junk value of the car is reportable on the dealer's books, although the amount of such income is usually very small.

- (17) Dealers frequently attend auctions to purchase cars for inventory. Many auctions give prizes with the purchase of certain cars or hold drawings for prizes during the auction. Frequently these prizes are of minimal value; however, occasionally, large items such as television sets and stereo equipment are prizes. Such prizes are includible as income to the dealership. New car dealerships may also give prizes to used car dealerships for purchasing certain types or quantities of cars during a given period. These prizes are also gross income.

## **G. Other Income Sources**

### **G.1. Auction Fees**

- (1) Auction fees are payments collected by a dealer for purchasing a specific vehicle for a customer at auction. Dealers will take a description of the vehicle desired by the customer as an open "buy order," then buy that specific type of vehicle when it goes through the auction.
- (2) In these transactions, typical auction fees are paid by the customer, and range from \$150 to \$350, depending on the cost of the car, the dealer's relationship with the customer, etc. The dealer may be reluctant to admit this type of fee income as the activity is discouraged by the auctions.
- (3) The best way to check for auction fee income is to obtain a printout of the vehicles purchased from auctions the dealer does business with and spot check the listings for inclusion in income. Check unusual purchases. For instance, if a dealer primarily sells domestic vehicles a \$20,000 Mercedes SL sports car purchased at auction would be out of character. There may be various legitimate reasons for such a purchase, such as a ready-made sale, or needing a leading car to put in a package deal with less desirable cars currently in inventory.

### **G.2. Credit Life and Disability Insurance Commissions**

- (1) Dealerships may offer life insurance and disability insurance to buyers at the time of sale. Generally, the insurance policy purchases are from unrelated insurance companies, with the dealer receiving a commission from the sale of the insurance.
- (2) Credit life and disability insurance (CLI) offered in conjunction with financing provides that if the insured event happens (that is, the buyer dies or becomes disabled), the insurance company will pay off the buyer's note. The commissions may range from 30 to 50 percent. If offered, CLI should be a large source of income.
- (3) Although most states allow car dealerships to sell CLI and earn commission income on each policy sold by the dealer, some states specifically prohibit car

dealerships and their employees from receiving any portion of the insurance premium attributable to the retail sale of a motor vehicle.

- (4) Therefore, in states such as Michigan, it is a common practice for an automobile dealer to establish a "dealer-related" insurance agency with a family member of the owner as an officer or owner of the dealer-related agency. It is a Michigan law violation if shown the dealer controls or manages the insurance company.
- (5) Auto dealerships in Michigan and states with similar laws may not deduct under IRC § 162(a) the commissions paid to the Finance and Insurance manager for the sale of CLI. These expenses do not relate to the dealership business, but rather to the "dealer-related" insurance agency. Michigan law further prohibits the dealer related insurance agency from reimbursing the dealership for the dealer's actual costs incurred relating to the sale of CLI.
- (6) If the examiner is unsure of the laws regulating the sale of insurance by auto dealerships in the state, contact the state Attorney General's Office, Department of Motor Vehicles, Department of Commerce, Financial Institutions Bureau, Insurance Bureau, or related state agencies for information.

### **G.3. Financing Rebates**

- (1) Financing rebates may take several forms. There may be a reserve account set aside by the finance company for recourse paper or aggregate loan performance. As the loan portfolio ages, some of the reserve may be refunded to the dealer. Some smaller finance sources may make kickbacks to the dealer for sending the finance company business.
- (2) In *Commissioner v. Hansen*, 360 U.S. 446 (1959), the Supreme Court held that when an accrual basis car dealer sells installment paper to a finance company, it must report as income not only the amount of cash received from the finance company but also the amount held in reserve by the finance company. This reserve is recorded as a liability to the dealer because the dealer has a fixed right to receive the reserve even though not until a later year.
- (3) To find if income from finance rebates exists, look at the dealer agreement with the finance company, loan proceeds and recorded income. Ask the dealership to provide account statements to determine the transactions in the reserve account. Review a listing of contracts financed, the amount financed and the withheld amount. Review the title work or lien, checking for common finance sources. If the dealer records deposit sources, the examiner may be able to spot check the deposit slips.

### **G.4. Extended Warranty/Service Contracts**

- (1) Dealers may offer extended warranties or service contracts for sale to customers. The contracts cover mechanical breakdown for a designated period of time or number of miles. Coverage only applies to parts or events specifically outlined in the contract. The customer purchases extended warranties/service

contracts separately from the purchase of the vehicle. The cost of the contract may be included in the finance package, but the cost of the contract is in addition to the cost of the vehicle and is negotiated and purchased by the customer separately from the vehicle purchase.

- (2) Extended warranties/service contracts are separate and distinct from warranties included with the vehicle at no additional cost. For example, some dealers offer 90-day warranties, known as “embedded warranties,” at no additional cost to the customer.
- (3) Used car dealers sell two basic types of extended warranties/ service contracts; contracts with a third-party obligor and contracts in which the dealership is the obligor. A third-party contract (referred to as an administrator obligor contract) is between the customer and an unrelated party. The dealer acts as an agent for the third party and receives a commission for the sale of the contract. A dealer obligor contract is between the customer and the dealer in the case of a dealer-obligor contract the dealer generally purchase insurance covering the dealer’s risk under the contract.
- (4) Tax treatment differs for the two types of contracts. For a third-party contract, the dealer reports commission income. A dealer obligor contract is more complicated. The dealer should report the sales price of the contract as income under the principles of IRC § 451. Any expenses incurred in servicing a vehicle covered under a contract are deductible when incurred under the principles of IRC § 461. If the dealership purchases insurance to cover its risk, it may choose to apply the accounting methods found in Rev. Proc. 97-38, the Service Warranty Income Method (SWIM). SWIM is a method of accounting and the dealership must follow the requirements to either adopt the method or change to the method. See Rev. Proc. 2015-13 and Rev. Proc. 2015-34.

## **G.5. Consignment Sales**

- (1) Some states allow dealers to sell vehicles on consignment. Generally, the vehicle owner enters into a contract with the dealership to receive an agreed upon amount upon the sale of the vehicle. The dealer receives either a flat fee or any excess of the sales price over the stated floor price agreed to with the owner.
- (2) The dealer may report the consignment sale in one of two ways. For example, when the dealer executes the consignment agreement, they assign a stock number to the consigned vehicle. Costs incurred in prepping and repairing the consigned vehicle post to its assigned stock number. The stock numbers assigned to the consigned vehicles may have a different numbering system or some other designation that quickly identifies the vehicle as a consigned vehicle. At the time of sale, the dealer assigns another stock number to the consigned vehicle to reflect the stated price the owner pays, and the dealer transfers the reconditioning costs to the new stock number. Alternatively, a dealer may not assign a stock number until the sale of the consigned vehicle occurs.

- (3) Under either method, the dealer may deduct incidental and reconditioning costs incurred by the dealer from the stated price paid to the owner.

## **G.6. Dealer Finance Income**

- (1) Dealers generally receive commissions on sales of financial products. Some dealers arrange with finance companies related to the vehicle manufacturer or other financial institutions to provide vehicle purchase financing for customers. The finance company frequently pays the dealer a commission or "finder's fee" based on the amount of the loan, or a set fee per loan.
- (2) Dealers may also have gross income from a rate spread on a loan. A dealer may have arranged with a finance company to write loans at a set interest rate, 8 percent, for example. When a car buyer purchases an auto from the dealership, the dealership may write the loan for a higher interest rate, 10 percent, for example. The excess interest generated by the higher rate is paid to the dealership by the finance company and is includible income. The rate spread in this example is 2 percent, the difference between the rate the finance company charges the dealer and the rate the dealer charges the car buyer.
- (3) A dealership may also provide its own financing for customer purchases. Often known as a "Buy Here/Pay Here" dealership, the dealership may collect on the buyers note in one of two ways. The dealership may require the customer to make monthly or weekly payments directly to the dealership. The portion of the monthly or weekly payment reflecting interest is income to the dealer. The principal portion of the payment, recognized as part of the sales income, will reduce the receivable. Alternatively, a dealer may sell a note or several notes (bulk sale) to a third party at a discounted amount. The discounts are often significant, usually exceeding 20 percent of the principal, and in some cases approaching 50 percent.
- (4) A dealer who finances a car sale customarily keeps a financing file. Since both the state and federal government under various statutes regulate the financing transaction, a dealer must maintain a paper trail of the transaction. A financing file usually contains the following documents:
  - Promissory Note.
  - Security Agreement.
  - Disclosure Notices required by law (if not contained in the Note or Security Agreement).
  - Credit Application and Credit Report.
  - Vehicle Title. (Some states send the title to the owner and provide a notation of lien on the title.) In those states, the dealer will not have physical possession of the title).



## **G.7. Sales taxes, registration and licensing fees**

- (1) The dealer collects and pays to the state some sales taxes and registration/license fees. In most states, used car dealers are required to charge sales tax on all retail sales. Many municipalities have their own retail sales taxes, which the dealers are also required to collect. In several states, charge the dealer an additional fee to register an auto with a lien. Passing on the lien fee is to the customer. When sold, new license plates may or may not be required. depending on state law. If license plates are necessary, many states require the dealer to collect the fee from the buyer and submit the additional amount to the state. The dealer may also have income from sales to other dealers or wholesalers and from the sale of vehicles at wholesale or retail auctions. Sales to other dealers are not subject to sales tax in many states. Check state and local laws to determine whether sales taxes apply to wholesale auto transactions. Some dealers include these fees in gross receipts and deduct the amounts paid to the state as an expense. Other dealers will not include these amounts in income or expenses.

## **H. Cost of Goods Sold and Purchases/Inventory**

### **H.1. Repossessed vehicles**

- (1) Repossessions are common in the used car industry. When repossession occurs, the taxpayer should place the vehicle into inventory at the vehicle's actual cash value (ACV), determined by a used vehicle guide such as the National Automobile Dealers Association (NADA) yellow book, Kelley Blue Book, or other guide generally accepted in the industry. The defaulting buyer receives a credit against the balance due for the ACV of the car. Any repossession costs increase the basis of the car. These costs can include attorney's fees, repossession fees, repair costs and re-title fees.
- (2) A deficiency can arise when the ACV is less than the amount owed, just as a gain can arise when the ACV is greater than the amount owed. For example, a car repossessed has an ACV of \$1,800. The amount owed the dealer at the time of the default on the loan is \$3,000 resulting in a \$1,200 deficiency. Using the same ACV of \$1,800 and the amount owed to the dealer at the time of the default on the loan of \$1,500, the repossession would result in a \$300 gain.
- (3) The dealer will try to collect the deficiency from the defaulting buyer; although state law will dictate, what collection procedures may be used. The dealer may return the vehicle to inventory and hold it for sale again or may dispose of the vehicle at auction. If the sales price is less than the ACV credited to the borrower, the dealer may attempt to collect the difference from the defaulting buyer. If the sales price exceeds the ACV credited to the buyer, the excess of sales price over ACV reduces the deficiency. If the repossessed car is sold with an overage (sales price exceeds the amount owed the dealer), the overage is repaid to the defaulting buyer. Sometimes shown on the contract such requirements vary from state to state. Many dealers will create a new stock

number for the repossession, while others will reassign (restock) the old number.

- (4) When a sale of personal property is reported under a deferred payment plan, the gain, (or loss?) on a subsequent repossession is equal to the Fair Market Value (FMV) less the seller's basis in the instrument obligation and less any repossession costs. The FMV of the personal property is measured on the day of repossession. The basis of the obligation is figured on its full-face value or its fair market value at the time of the original sale, whichever was used to figure the gain or loss at the time of sale. From this amount, subtract all payments of principal received on the obligation. If the repossession discharges only part of the obligation, calculate the basis in that part.
- (5) The fair market value is the price at which a willing buyer would purchase a vehicle from a willing seller with neither party being under any constraints to complete the transaction. The FMV can be different from the Actual Cash Value, which is based on adjusted wholesale values.
- (6) Alternatively, the dealer may obtain bids from other dealers or simply sell the car at an auction rather than returning the vehicle to inventory for future sale. In those cases, the dealer credits the defaulting buyer with the net sales price of the car.

## **H.2. Purchases from Other Dealers**

- (1) Purchases from other dealers are like purchases from auctions. However, there may be no written record of the transaction, and the transfer of title probably will be by a reassignment of title to the purchasing dealer. Frequently, the dealer may make a package purchase. This is a purchase of several cars for a lump sum. The purchasing dealer should record the cost of the cars based on the relative ACV of each car to the total purchase price of the package. The ACV of cars sold in a package can vary greatly since it is common to put one or two cars that are difficult to sell in a package, with the expectation that the purchaser will want the other cars enough to accept the entire package. As with cars purchased at auctions, increase the cost of the car by any reconditioning costs incurred in preparing the car for sale.

## **I. Expenses**

### **I.1. Cost of Labor**

- (1) Labor costs involved in reconditioning and delivery of autos are required to be included in cost of goods sold. The costs attributable to vehicles in ending inventory should be included as part of the inventory value. Labor costs may be incorrectly included in "outside services" or other such accounts.

### **I.2. Reconditioning Expenses**

- (1) A dealer will generally have substantial reconditioning expenses, which are the costs that the dealer must incur to ready a vehicle for sale. The total dollars spent on reconditioning cars may be one of a dealer's largest expenses,

depending on the condition of vehicles normally purchased. Add to the inventory cost of each car the cost of its reconditioning.

## **J. Inventory Valuation**

- (1) Dealers acquire used vehicle inventory either by purchasing the vehicle or by taking a vehicle in trade when selling a customer, a different vehicle. Inventory valuation of a purchased vehicle is different that valuation of a traded in vehicle.

### **J.1. Trade-in vehicles**

- (1) When acquiring a vehicle via a trade in, the dealer has generally engaged in a negotiation with the customer regarding the trade in allowance for the vehicle. The trade in allowance is the amount the dealership agrees to allow the customer against the cost of the new vehicle purchase. Since the trade in allowance is an amount negotiated between the dealer and the customer, it may not represent the cost of the vehicle.
- (2) Generally, a dealership should determine the inventory value of a traded in vehicle by consulting an industry valuation guide such as Kelley Blue Book, Black Book, or the NADA Used Car Guide. Using a guide is a permissible method of valuing ending inventory (see *Brooks-Massey Dodge, Inc. v. Commissioner*, 60 T.C. 884, 895 (1973) (citing Rev. Rul. 67-107, 1967-1 C.B. 115))
- (3) The selected guide must be used consistently and changing to a different guide is a change in method of accounting (See Rev. Proc. 2016-29 DCN #138 and successors). Additionally, the guide must be used appropriately including using the average wholesale value (not the retail or trade in value) provided in the guide and making any adjustments required based on options, mileage, or condition of the vehicle.
- (4) Adjust the value of the car for reconditioning costs. Common expenditures include cleaning (detailing) mechanical repairs, body damage repairs, interior repairs, painting, and tires.
- (5) Examiners may find that some dealers rely more on experience and personal judgment than on a valuation guide. Others may rely solely on their professional judgment of the value of the car in that area at that time. Rev. Rul. 67-107, 1967-1 C.B. 115, states that used cars taken in trade as part payment on the sales of cars by a car dealer may be valued, for inventory purposes, at valuations comparable to those listed in an official used car guide (as the average wholesale prices for comparable cars).
- (6) Some dealerships may undervalue their year-end inventory to overstate the cost of goods sold by using unacceptable methods of valuation. Some dealers use personal knowledge and year-end auction prices for similar cars as the means of valuing inventory. The dealers rationalize that auction value is the price one could get for their cars if forced to sell the inventory at auction in a

business closing. However, this may not be the dealer's primary market and would be an unacceptable valuation method.

- (7) Dealers may also use loan values to determine inventory value. The dealer may state he could get better loans from the bank by using the loan value of the cars as the inventory value. This too would be an unacceptable valuation method.
- (8) While the industry may recognize the use of experience and personal judgment to market value inventory, the Internal Revenue Service and the courts do not accept such methods of valuation. Valuations must be comparable to those listed in an official used car guide. Courts have accepted the officially recognized valuation guide for tax purposes. See *Brooks-Massey Dodge, Inc. v. Commissioner*, 60 T.C. 884 (1973) and Rev. Rul. 67-107, 1967-1 C.B. 115.

## **J.2. Inventory Records**

- (1) The smaller dealers may use single entry systems. Records may be a check register or ledger sheet showing the purchases of inventory and other expenses listed together.
- (2) Some dealers will use a perpetual inventory method, updating inventory with each sale and purchase. With this method, the dealer will know the value of his or her inventory at any given time during the year since throughout the year single adjustments are made to the inventory account and cost of sales.
- (3) A dealer takes a physical year-end inventory when a dealer uses the periodic inventory method. The dealer may write the inventory down and make one entry to record the inventory value less the write-down. In such instances, that will be the only entry at year-end to establish inventory at the lower of cost or market. The dealer should maintain a record of the write-down taken on each vehicle in inventory.

## **J.3. Inventory Write-downs**

- (1) See the Inventory Write-Down chapter of the Inventory General book on the Inventory and 263A shelf within the Corporate/Business Issues & Credits Knowledge Base in the Servicewide Virtual Library.
- (2) Year-end write-downs on used vehicles are allowable under the lower of cost or market (LCM) method of accounting when meeting certain requirements under the regulations. The Secretary's regulations provide that the lower of cost or market is an acceptable method of accounting for inventory, (Treas. Reg. §1.471-2(c)). Treas. Reg. § 1.471-4 provide the rules to apply LCM.
- (3) Under the lower of cost or market method, as of the end of an inventory period (e.g., as of year-end) the cost of each item of inventory is compared to its market value, and the lower of the two is recorded as the basis of that item of inventory for tax purposes (Treas. Reg. §1.471-4(c)). If the market value of inventory is lower than its cost, the taxpayer "writes down" the basis of the inventory to the lower market value, thereby reducing gross income. See, e.g.,

Thor Power Tool Co. v. Commissioner, Thor Power Tool Co. v. Commissioner, 439 U.S. (1979) at 530A.

- (4) Auto dealers may improperly determine cost and/or market value when computing year-end inventory value. Used vehicles may be acquired by purchase or when traded in upon the purchase of a different vehicle. The “cost” of a vehicle varies depending upon whether it is a purchased vehicle or acquired by trade-in.
- (5) Purchased vehicles should be included in inventory at cost, i.e. the purchase price. The cost of any repairs, detailing or other work increase the inventory value. Vehicles taken in trade must be valued using an appropriate used vehicle guide in effect at the time of trade in. (See Rev. Rul. 67-107) Cost of repairs, detailing or other work performed on the traded in vehicle must also be added to the inventory value.
- (6) Examiners may find that vehicles taken in trade are included in inventory at the trade in allowance amount rather than the amount from a used vehicle guide. The trade in allowance is the amount the dealership agrees to allow the customer against the cost of the new vehicle purchase. Since the trade in allowance is an amount negotiated between the dealer and the customer, it may not represent the cost of the vehicle for purposes of LCM.
- (7) For normal goods (first quality goods with no defects and having an open market) under ordinary circumstances, the regulations define “market” as “the current bid prices prevailing at the date of the inventory for the basic elements of cost reflected in inventories of goods purchased and on hand, goods in process of manufacturing, and finished manufactured goods on hand.” (Treas. Reg. § 1.471-4(a) (1)). The courts have interpreted “bid price” to mean, “replacement cost, that is, the price the taxpayer would have to pay on the open market to purchase or reproduce the inventory items.” (See Thor Power Tool Co., supra. at 534).
- (8) Typically, dealers consult a used vehicle guide such as Kelley Blue Book, Black Book, or other guide known in the industry, to value inventory at year-end. Using a guide is a permissible method of valuing ending inventory (see Brooks-Massey Dodge, Inc. v. Commissioner, 60 T.C. 884, 895 (1973) (citing Rev. Rul. 67-107, 1967-1 C.B. 115) The selected guide must be used consistently and changing to a different guide is a change in method of accounting (See Rev. Proc. 2019-43 DCN #138). Additionally, the guide must be used appropriately. Use the average wholesale value (not the retail or trade in value) provided in the guide when making any adjustments required based on options, mileage, or condition of the vehicle.
- (9) The dealership then determines a vehicle’s ending inventory value for the year by comparing the value per books to the value determined at year-end using the guide. Any reduction in value is recorded as a vehicle write down. Examiners should be aware that some dealers might improperly determine a vehicle’s year-end value by reducing all vehicle values by a certain percentage

or set dollar amount. Other dealers may determine a write down based on "experience."

- (10) The taxpayer has a substantiation responsibility when applying the Lower of Cost or Market (LCM) method. The write-down of inventory from cost to market value based on estimates is not allowable, (Treas. Reg. §1.471-2(f) (1)). In *Best Auto Sales T.C. Memo 2002-297*, the Court ruled that the dealership must maintain objective evidence related to its used car write-downs such as records to substantiate item-by-item comparisons of cost or market value.
- (11) When the taxpayer seeks to value its inventory using LCM under Treas. Reg. § 1.471-2(c), it must substantiate its lower inventory valuation by providing evidence of actual offerings, actual sales, or actual contract cancellations. In the absence of objective evidence of this kind, the assertions of a taxpayer as to the 'market value' of its inventory are not cognizable in computing its income tax." (Sam Goldberger, Inc., 88 T.C. at 1555 (citing *Thor Power Tool Co*)).
- (12) Some of the dealers purchase used vehicles while others take used vehicles in trade. If the dealer purchased the vehicle substantially prior to year-end, then the used vehicle guide is a reasonable indicator of the vehicle's value. If the taxpayer purchased the vehicle near the year-end, then the purchase price of the vehicle is a better indicator of the market value of the vehicle and not a used vehicle guide.

## **K. Expense Issues**

### **K.1. Commissions and fees**

- (1) Some owners solely operate small used car dealerships, so the dealership will not have commission expenses. Larger dealerships will employ salespeople who will receive commissions. Commission income is wages and salaries for employment tax purposes from the sales of vehicles. Contracts between employer and employee should specify how commission wages are determined.
- (2) Dealerships may also pay commissions or finder's fees to other dealers or individuals for locating a specific make or model the dealer needs on his or her lot. Normally, these finder's fees are not considered wages since the amount is paid to someone outside the dealer's business. These expenses should be included as part of the inventory costs. If amounts paid to an individual exceed \$600 for a calendar year, they require a Form 1099 Miscellaneous filing.
- (3) Dealers may incur charges referred to as "hiking" or "shuttling" for the transportation of vehicles. Generally, the dealer pays the expenses of hired individuals who drive cars between dealers' lots and to or from auctions. The expenses paid are inventory costs under IRC § 263A if they are associated with moving or shipping property acquired for resale.
- (4) They may be subject to employment taxes, depending on the facts and circumstances. In *Leb's Enterprises, Inc.*, 85 AFTR2d 2000-450, January 24,

2000, Car shuttlers who transported vehicles from place to place where employees of the company and the company was responsible for applicable employment taxes.

## **K.2. Demonstration Expense**

- (1) Used vehicle dealerships may or may not have demonstrator vehicles. If the dealership does provide demo vehicles, examiners should consider Rev. Proc.2002-56 for discussion of the issue and available safe harbors.
- (2) The owner of the dealership may use vehicles on the lot for commuting and other personal purposes. If this is the case, corporations should report income on Forms W-2 for the personal use of the cars, and a sole proprietor should reduce expenses.
- (3) The taxpayer may argue that an owner's use of dealership vehicles is tax-free because the owner qualifies as a full-time salesperson under Treas. Reg. § 1.132-5(o). This § defines who is a full-time salesperson, and what qualified automobile demonstration use is. The taxpayer may also make other arguments to justify using inventory for personal use, such as: he or she had the car repaired and was test-driving the vehicle to make assure proper repair, or he or she was driving the car around with a for sale sign as advertising. The examiner will address these arguments on an individual basis, considering the facts and circumstances involved.

## **L. Related Finance Companies**

- (1) The use of related finance companies (RFC) is a common practice in the used car industry. Such companies serve many valid business purposes outside of any tax benefits. However, used and new car dealers use RFC's to reduce or defer the reporting of income.
- (2) An owner of a dealership will generally establish a related finance company as a separate corporation and own it 100%. The RFC may operate from a location separate from the dealership or from a space within the dealership itself.
- (3) There are at least three potential issues that may be present when examining an RFC:
  - What are the economic reasons for the arrangement?
  - Is the RFC valid in form?
  - What is the economic substance of the discounting transactions (this is the most critical issue)?
- (4) Economic reasons for an RFC arrangement include:
  - Providing credit to enable the purchaser to buy a car.
  - Many, if not most of the purchasers that utilize the services of an RFC do so because of an inability to secure credit. The RFC serves a useful

purpose in providing credit to individuals with little credit, no credit, or bad credit. Payment schedules are typically on a weekly or monthly basis.

- Improving the collection of accounts receivable.
- An RFC can significantly enhance the collection of accounts receivable by requiring the borrower/buyer to remit payments to a third party, even though they are a related third party. Experience has shown that when a customer makes a payment directly to the dealer then bad experience with the car often leads to a default on the note for the car. This, in turn, creates a collection problem, and possibly a publicity problem for the dealership. On the other hand, if an RFC is involved, experience shows that the customer is less likely to default on the payment. Given the general creditworthiness of the customers, this is a significant advantage. Some dealers, through effective management and controls, have RFC discount rates lower than what they can obtain from third parties and still make a profit on their RFC financing operations.
- Avoiding licensing and other regulatory requirements on the dealer entity.
- Many states have licensing requirements for finance companies. Establishing an RFC permits the dealer to isolate liability for violation of any requirements in a separate entity, without jeopardizing the status of the dealership. In addition, some states have capital requirements for finance companies that may interfere with the normal operations of a dealership.
- The RFC may prevent adverse publicity due to repossessions and other collection actions from affecting the dealership.
- Repossession and collection problems are a daily fact for buy here/pay here dealers. Creation of an RFC permits a new entity to undertake these actions, thereby insulating the dealer from any adverse publicity. Even in states where disclosure of the relationship is required, the resulting publicity is usually less adverse when an RFC is used.
- RFCs insulate the dealership from the financial risk of default on the notes.
- The industry deals with a customer base that generally has poor or non-existent credit therefore, the default rate on buy here/pay here notes is substantially higher than on general bank loans. The higher default rate provides for both the interest rates charged by the dealer or finance company and the reserves that independent finance companies generally maintain. A separate RFC removes the financial risk from the dealership entity.

## **L.1. Diversification of ownership**

- (1) Since the financing of used cars is not inherently a part of a dealership, an RFC permits the dealer to provide ownership in that specific business by both family



and non-family members without diluting ownership in the dealership. This allows the dealer to separate the two businesses and reward certain employees or other individuals with an ownership interest in a segment of the business. It also provides a more accurate accounting of the financing activities when dealers report to banks and other financing entities.

- (2) A properly operating RFC also focuses the collection function outside of the dealership itself, which relieves the sales personnel from a task that is time consuming.

## **L.2. Validity or Form of RFC**

- (1) The second issue that the examiner should consider is how a valid RFC is structured and operated. Since the purpose of the RFC is to isolate liability or segregate transactions in a separate entity, the RFC should meet several criteria for the Service to recognize it as a separate, valid business including:
  - be a separate, legal entity;
  - meet all licensing requirements of the jurisdictions in which it operates;
  - have adequate capital to pay for the contracts;
  - have its own employees and compensate them directly;
  - obtain and maintain all appropriate local business and similar licenses;
  - have a separate telephone number;
  - have a separate business address, which may be a post office box. Even if the RFC maintains a separate business address, it is common for the RFC to have an office at the dealership;
  - maintain a separate set of books and records;
  - comply with all title, lien, and recordation rules in the jurisdictions in which it operates;
  - notify customers of the purchase of their notes;
  - with a dealership have a purchase contract for the receivables that both complies with the appropriate state law and provides evidence of how the FMV of the receivables was determined;
  - pay the dealer for the receivables at the time of purchase;
  - can generate the cash to make the payment from any combination of capitalization of the RFC, bank or third-party borrowings, or borrowings from related entities or shareholders. Borrowings from related entities or shareholders can diminish the validity of this factor; and
  - should operate in a business-like manner.
- (2) While not all of these attributes need be present, to the extent that they are absent, a question as to the substance of the RFC exists.

### L.3. Economic substance of an RFC

- (1) The third issue that the examiner should address is the sale of discounted receivables at fair market value (FMV). Sales of receivables must have economic substance to qualify for tax purposes; valid business reasons alone will not suffice.
- (2) The FMV of a receivable or group of receivables will depend on several factors, purchasing receivables are not an exact science, and many subjective factors enter into the determination of value.
- (3) Factors that may directly influence the amount of discount include:
  - Absence of or poor credit history.
  - History of payments on the note
  - Amount of time left on the note.
  - The age of the vehicle.
- (4) Experience shows that some third-party finance companies acquire the receivables from dealers at up to a 50 percent up-front discount. The discounts may apply whether the finance company buys in bulk or "cherry picks" the best accounts.
- (5) Back-end reserves may be part of the sale of notes. Back-end reserves are funds maintained by the finance company and releasable to the dealer at the time the loan is paid. The back-end reserves can restore the dealer's profit on the sale to 100 percent, less any transaction costs. When an RFC purchases at a deep discount the examiner should inspect them for these back-end reserves.
- (6) A dealership can establish an RFC and discount its receivables in a fashion that is acceptable for tax purposes.

### L.4. Summary

- (1) The discounting transactions must have economic substance. The examiner should consider all the relevant facts and circumstances. Primary reasons for the dealer to sell receivables may be to obtain cash to improve cash flow of the dealership, or to shift risks. If both reasons are missing, it is a good indication that the sales transaction lacks economic substance. The RFC must perfect the form of the transactions and the form of the entity. The RFC must sell receivables for fair market value. The seller and purchaser must base the discount on some reasonable factors, not on an arbitrary determination of the discount rate.
- (2) An examiner should consider the following issues that may be present in an RFC examination:
  - Whether the examiner should disallow a loss incurred by a car dealer from the purported sale of notes receivable to a related finance company because the related finance company existed only in form and the

transaction between the dealer and related finance company lacks economic substance.

- Whether IRC § 482 applies to the loss claimed by a dealer from the sale of notes receivable to a related finance company when the notes receivable sold are at less than the fair market value.
- Whether IRC § 267 applies to a loss from the sale of notes receivable by a car dealer to a related finance company Are the dealer and related finance company members of a controlled group for the purposes of IRC § 267 and thereby eligible for the special loss recognition rules of Treas. Reg. § 1.267(f)-1(f)?

## **M. Non-Prime or Sub-Prime Finance Contracts**

- (1) Because of poor credit, many potential vehicle purchasers cannot obtain financing directly from banks, credit unions, or manufacturers' finance companies. These purchasers referred to as non-prime or sub-prime consumers, depending on their credit rating (non-prime having a higher credit rating than sub-prime). To tap into this large market, many vehicle dealerships (particularly used car dealerships) have established relationships with specialized lenders who offer retail installment agreements to sub-prime customers.

### **M.1. How a Non-Prime or Sub-Prime Plan Works**

- (1) To facilitate cash flow and to avoid collection responsibilities, the dealerships often transfer non-prime or sub-prime installment contracts to an unrelated finance company shortly after the deals are consummated for an upfront cash advance and the possibility of additional cash payments in the future (sometimes called "back end" payments).
- (2) Dealerships may do business with several finance companies and may have paid a fee and entered into a servicing agreement with each finance company prior to transacting business with it. Servicing agreements vary among finance companies, and one finance company may have a variety of programs, but the basic premise of most of these types of programs is the same.
- (3) Upon transfer of the installment contract, the finance company pays the dealership an advance ranging from 50 to 75 percent of the contract, depending on the credit rating of a customer or the dealership's aggregate pool of contracts. The advance is based either on the face amount of the contract without interest, or on the total contract amount including interest.
- (4) After paying the advance, the finance company collects the installment payments from the vehicle purchaser for a fixed percentage of each payment, often 20 percent. In addition, the finance company is reimbursed for any out-of-pocket collection cost incurred. Only after recovering the fixed percentage fee, out of pocket collection costs, and the advance, will the finance company begin

to pay the dealership for the remainder of the contract, e.g. the back-end distribution.

- (5) Generally, the finance companies apply the collections on the installment contracts in the following order:
  - To pay the fixed percentage collection fee
  - To reimburse out-of-pocket collection costs (e.g. repossessions related expenses)
  - To repay the advance from the finance company to the dealerships, and
  - To remit any remaining funds to the dealer (back-end distribution)
- (6) Assuming a 20 percent fixed collection fee, and if the finance company has no out-of-pocket collection costs, the dealer has the potential through the advance plus back-end distributions to receive 80 percent of the installment contract (either the face amount of the contract or the face amount of the contract plus interest, depending on the servicing agreement). However, because of the order in which the collections are applied, dealers may not receive any back-end distributions because the collections received may be subject to a high default rate and may never exceed the sum of the 20 percent service fee, out-of-pocket costs, and the repayment of the outstanding advances.
- (7) The chances of receiving back-end distributions reduced further because the finance companies aggregate the installment contracts rather than carry them individually. For example, if a transfer 20 non-prime or sub-prime contracts, the advances from the finance company for all 20 contracts will be aggregated, and only after collections are received that exceed the cumulative advances on all 20 contracts will any back-end distribution be made. Thus, if the finance company keeps issuing advances, the cumulative advance balance increases, and the collections received may never be enough to cover this ever-increasing advance balance.
- (8) To rectify this some finance companies, offer pool capping. Under this arrangement, the dealership may pay an additional fee to cap off one pool (or group) of contracts and to create a new pool for additional contracts. Pool capping speeds up the time in which the dealer is eligible to receive back-end distributions because it segregates a group of contracts, and collections received on those contracts apply exclusively to those contracts. Advances on contracts in another pool do not repay the collections on those contracts. Once the advances on the contracts in that specific pool are repaid and the 20 percent collection fee and any out-of-pocket costs are covered, the dealership will begin to receive back-end distributions on those contracts. The same process applies to all capped pools of the dealer. The terms of pool capping arrangements must be carefully analyzed, however, since cross collateralization of pools may occur (payments made on contracts in one pool may be applied to another pool), diminishing the benefits of capping.

- (9) Non-prime and sub-prime arrangements change frequently and adjust to current market conditions. Examiners should consider all the facts and circumstances pertinent to a specific servicing agreement when examining these issues.

## **M.2. What are the issues?**

- (1) The issue discussions are limited to dealership reporting and do not address treatment of these contracts by finance companies.
- (2) There are several potential issues associated with a dealerships' tax reporting of non-prime and sub-prime contracts, including:
- Is the transfer of the contract from the dealership to the finance company a sale of the contract? Alternatively, is it merely a pledge of the contract to collateralize a loan made to the dealership by the finance company?
  - How the cash advance is reported?
  - How the payment of the fixed percentage collection fee is reported?
  - Are back-end distributions contingent payments?
  - When the back-end distribution is reported?
  - How the back-end distribution is valued?
  - Methods used computing and reporting interest.
  - The reporting of enrollment fees and capping fees?
  - Are adjustments to this issue changes in method of accounting?
- (3) For additional guidance refer to, LTR 9840001; LTR 199909003; LTR 199909002 Based on the facts presented, the rulings reached the following conclusions:
- The transfers of customer notes from a used car dealership to an unrelated finance company are sales.
  - The dealer's amount realized on the sale equals the cash received from the finance company plus, the fair market value of the dealer's right to receive future distribution payments.
  - The FMV of the future payments is not necessarily \$0.
  - The distribution payments are contingent and subject to the rules of IRC § 483(f).
  - Each distribution payment allocated to principal and interest.

## **M.3. Sub-Prime Records**

- (1) Most records for sub-prime deals will be like a normal deal. For example, the transaction should have a deal/vehicle jacket. The jacket may be an envelope or a file folder for each vehicle, which includes all the dealer's documentation

related to that vehicle such as the sales invoice, purchase invoice, copy of the title, and repair receipts. The jacket often also lists detailed information about the vehicle's purchase and sale, including the dates, amounts, and individuals or companies involved and documentation of the transfer of the note if applicable.

- (2) Documentation should include a retail installment agreement specifying how the customer will pay for the vehicle. Sometimes the retail installment agreement specifically states that the account will transfer to a finance company. In addition, the dealer usually receives a payment voucher from the finance company that shows the customer's name and amount received, and these vouchers may be in the vehicle jacket.
- (3) The dealer also prepares other paperwork as required by the finance company, retaining copies in a jacket or separate file. Documentation should include the non-prime or sub-prime customer's verification of employment and utility bills to show the home address, the computation of the advance to be received from the finance company, the insurance information form, and the notice of security interest.
- (4) If it is determined that the dealer transferred finance contracts to an unrelated finance company, the examiner should request the following additional information for each company.

#### **M.4. Servicing Agreement (referred to as the dealer agreement).**

- (1) The Servicing Agreement defines the responsibilities of the dealer and the finance company. It provides definitions, explains the advances and how the collections will be applied, and shows how the agreement can be terminated. In addition, if the finance company changes the advance computation or other provisions of the agreement, the dealer will receive an addendum or other notification of the changes by the finance company.

#### **M.5. Dealer Manual & Other Literature**

- (1) The dealer manual may contain various items of information, including a sample of customer paperwork with detailed advance computations. The finance company may send the dealer literature on new programs or new features such as pool capping.

#### **M.6. Account Statements**

- (1) The finance company sends statements (usually monthly) to the dealer summarizing advances, collections, fees, and other pertinent information. The summary may show detail by customer of the last payment date, amount of payment, and a bad debt when written-off.

### **IX. Chapter 9 : Auto Body/Repair**

#### **A. Introduction**

- (1) Most Auto Body Shops are small to medium sized businesses operated as sole proprietorships, small partnerships, or closely held corporations. They range in size from the corner shop to large franchises with many locations. Specializations range from domestic or foreign vehicle repair to classic vehicle restorations. They are combinations of service type businesses with retailing aspects mixed in. Although they provide the labor and skill, they must also purchase and resell the needed parts.
- (2) Environmental agencies also regulate body shops. Because of today's tighter air quality restrictions, the amount of hazardous materials it may use on a day-to-day basis is limited. Hazardous emissions include paints, toners, and thinners used in spray form. Because violations of air quality regulations can bring stiff penalties, these regulations are often closely adhered.

## **B. Description of Auto Body Repair Process**

### **B.1. Repair/Replacement**

- (1) There is a distinction between the term "repair" and "replace." These two terms involve separate processes. If a body component has been completely mangled, it will simply be "replaced." This is the easiest type of bodywork since the process involved is simply purchasing the part, installation, and painting. "Repair" work may involve pounding out a dent if it is simple, or it may involve straightening the frame which is the most extensive and complex type of bodywork.
- (2) The advent of unibody construction makes the repair process even more complex. In the older domestic vehicles, components bolted to a frame, which acted as the support for vehicle road shock. In unibody construction, the components act as the frame. Simply replacing the component may not be enough to restore a damaged unibody vehicle. The checking of other components is necessary to determine if they shifted from the original positions.
- (3) Another change is the safety concept of "energy absorption." Essentially, this allows the body to absorb a higher percentage of the impact from a high-speed collision. This also means that the body collapses more easily. This makes the vehicle more susceptible to damage at lower speed impact as well. In the chapters to follow, the term "repair" refers to either the repair or replacement process unless another specific distinction is made.

### **B.2. Paint Process**

- (1) After repair of the vehicle, shops paint the vehicle to match the original color as nearly as possible. If the vehicle has the factory original paint, the "formula" for that color may be available by the manufacturer. Paint mixing systems vary with each body shop. Some maintain the formulas on microfiche while others keep them in a computer database. Smaller body shops may depend on the paint stores to mix the needed paint. Before the paint is applied, the repaired part is sanded and sealed to remove scratches and prepare the surface. After it is painted, applying clear coat to give the paint a shiny or metallic look.

### **B.3. Other Processes**

- (1) A collision may not only damage the body exterior but also the mechanical functions inside. Some body shops will perform minor mechanical work, such as radiator replacement or easy electrical work. Body shops usually sublet major mechanical work to an auto repair shop.
- (2) Other processes include tire and glass replacement, upholstery repair, and cleaning of the vehicle which involves washing and waxing the exterior and cleaning and scenting the interior.

### **B.4. Estimation Process**

- (1) An examiner should be familiar with the estimating process used in reporting gross income. They use an estimate to provide the customer with the final cost or as an agreement between the shop and the insurance company as to the total costs of the job.
- (2) The body shop, the insurance company, or an independent appraisal company may prepare the estimates. The major sources of information from which estimates are prepared are the Mitchell Collision Guides. These guides are available in book form or as computer software. They provide the Auto Body Shops with the information required to estimate repair costs. The actual process of estimating is very easy for the replacement of a part as opposed to repairing it. This is due to industry standards provided by services such as the Mitchell Collision Guides. Insurance companies also have their own in-house standards and rates. Smaller insurance companies use independent appraisal companies that specialize in auto repair estimates.
- (3) If the Auto Body Shop has prepared an estimate, the insurance company that is paying the claim must still approve it. These estimates are subject to some negotiation between the body shop and the insurance company. Usually, the negotiated items will include the labor charges and the use of used or "after-market" parts.

## **C. Some of the differences between body and repair shops:**

### **C.1. Body Shops:**

- are mostly reimbursed by insurance companies;
- buy parts primarily from dealerships;
- generally, buy what is needed for a specific job but may stock some paint materials and small supplies;
- see their customers far less often;
- usually use estimate forms with their repair orders;
- generally, charge a different rate for metal, paint, and frame labor;



- sometimes pay all or portion of their staff on a based percentage of labor billings; and
- generally, have work- in-process but little parts, materials and supplies inventory.

## **C.2. Repair Shops**

- have some insurance work but most of the costs are paid by the owner of the vehicle;
- buy parts from dealerships but frequently buy bulk parts from other suppliers at lower costs and may also stock items such as batteries, etc., on consignment;
- often order common parts in bulk as well as lubricants and fluids;
- are likely to have a steady clientele and a lot of repeat and family business;
- may not use the estimate forms seen in a body shop;
- may charge a flat rate for mechanical labor which is usually billed at a higher rate;
- usually pay an hourly wage; and
- usually have less work-in-process and stock parts, materials, and supplies.

## **D. Initial Interview**

- (1) Since the Auto Body and Repair Industry is also a service operation, question the Auto Body Shop regarding the processes involved. Ask about the type of vehicles repaired. Find out how much time it takes to complete an "average" job. Determine how the Auto Body Shop treats the workers, that is, employees or independent contractors.
- (2) Find out what function the officers, shareholders, and relatives have in the corporation. Officer salaries may be subject to excess compensation issues. Ask if shareholders or their relatives have dealings with the corporation as perhaps landlords, suppliers, or customers.
- (3) The examiner should direct questions about the accounting records to the bookkeeper, controller, secretary, or accountant, rather than the principals, unless they directly involved in the record keeping. It is important to know exactly how the records are kept and become familiar with any unfamiliar notations used by the Auto Body Shop. This is particularly true of computer-maintained records that may use many different sets of reference codes.
- (4) The acquisition of substantial new machinery and equipment might suggest a shift in operations. Many luxury autos on the depreciation schedule could prompt specific questions about the use of the cars in the business and such

events as ownership changes, theft losses, and asset sales would merit specific inquiry.

(5) Some questions to incorporate into an auto body/repair interview follow below. The listing includes only items relating to the repair process, sales, and officer/shareholder duties. Add questions about the business history, accounting methods, internal controls, and mandatory items:

- When are initial estimates made? Is any charge made for estimates?
- After the initial estimate is made, how are contacts made with the insurance company?
- Does the estimate vary with the final bill?
- Are repair orders used in sequential order?
- When is the repair orders dated? (Is the order dated when the customer authorizes the repair either orally or in writing, or is it only when the customer signs the order, etc.?)
- What happens if a repair order is voided? Is the repair order thrown away or retained? How many orders are voided?
- Do some repair orders require supplements? Do supplements require a new repair order written? When is payment due for the supplement? Is the vehicle released prior to the receipt of the supplement? When supplement be recognized as income?
- When are parts ordered for a repair job?
- How often is paint purchased?
- At what discount do you purchase parts? (Varying based on make of vehicle).
- What is the labor rates charged for repair (Varying depending upon type of work needed)?
- Do you supply loan cars? If so, do you get rebates from rental companies for the loaners?
- When will a job be booked as a sale?
- Do you have steady referrals from dealerships?
- Are deductibles ever waived? What would be the circumstances?
- Are liens ever placed on vehicles for sale or recovery of expenses?
- If the Auto Body Shop maintains inventory on the return, ask how the inventory has been computed and of what it is comprised. Does it have any consigned items?

- How is the payroll determined for the repair staff? (Hourly wage, salary, percentage of labor charge or a combination).
- How the repair staff is classified/treated - employees or independent contractors?
- If Auto Body Shop is a C-Corporation, what are the duties of the current shareholders?
- What is the current percentage ownership of each shareholder?
- How is officer compensation (salary, bonus, fringe benefits) determined?
- Does any officer, relative, or group of which an officer is a member, have dealings with the corporation other than as an employee? (For example, as a lessor, a vendor, or consultant).
- Does the corporation own, or lease vehicles assigned for the use of specific officer/shareholders?

## **E. Tour of Business**

- (1) A typical Auto Body Shop will usually have a parking area for making estimates, and storage of vehicles, repair stalls for light and heavy work, storage areas for paints and other supplies, and offices where the officers can order parts and perform day-to-day paperwork.
- (2) If the Auto Body Shop has not shown any inventory on the return, are there parts lying around the premises awaiting installation? Does the storage area hold paint cans? Does it appear that there is adequate space for vehicles to be stored for a few days or even weeks at a time? Note any major equipment lying around which appears to be no longer in use.
- (3) If the Auto Body Shop has stated that the workers are independent contractors, notice if they are wearing uniforms of the Auto Body Shop. Are they utilizing the major equipment provided by the Auto Body Shop? Are they working on the premises of the Auto Body Shop?
- (4) Look at the size of the lot and any adjacent areas which may not appear to be related to the Auto Body Shop and note the addresses. The Auto Body Shop may rent the adjacent area and may be sub-leasing it to a third party. A review of the lease agreements should show the addresses under lease. This should show up as other income or a credit to rent expense.
- (5) Ask the Auto Body Shop to explain the repair process from the tear down process to the final drying of the paint. With an adequate understanding of the repair process, the documentation reviewed during the audit may be easier to interpret.

## **F. Books and Records**

## F.1. General Books and Records

- (1) A distinctive journal encountered consistently is the sales journal that will usually break sales down into the following categories:
  - Parts/Paint/Material sales
  - Labor Sales: Further break down will be metal labor (body work), paint labor, and frame labor
  - Sublet Charges
  - Towing
  - Storage
  - Sales Taxes

## F.2. Specific Documents

- (1) In performing an effective audit, note that many documents beside the usual purchase invoices, cancelled checks, etc. are helpful:
  - **Estimates:** Estimates may be prepared by the Auto Body Shop, the insurance company, or an independent appraisal company hired by the insurance company. Information available will be on an item-by-item basis. The following may be included on the estimate:
    - Insurance Company - Name, address, and telephone number of specific offices handling the claim.
    - Date of Estimate - This date may be important in determining when the vehicle was brought in for inspection.
    - Date of Loss - Date vehicle was in the accident
    - Vehicle description - Vehicle type, model, year, identification number, license number and
    - mileage when brought in.
    - Customer name and whether that person is the claimant or the insured party. An address and phone number may be listed.
    - Part description - Details whether the part fits on left or right side of vehicle, front or rear, and the specific name.
    - Part Number assigned by the manufacturer.
    - Suggested retail price of the part.
    - Allowed labor hours to install the part.
    - Paint materials, their cost, and the allowed labor hours.
    - Sublet expenses such as mechanical repairs, glass replacement, anticipated costs, and allowed labor hours.
    - Towing and storage charges
    - Sales tax on parts and material.
  - **Repair Orders:** These vary in detail and complexity. This document differs from the estimate in that it records the actual costs associated with

the repair of the vehicle. It will usually summarize the information rather than list the individual items. Some listed items include:

- Customer name, address, and phone numbers.
  - Repair order number - Repair orders are usually sequentially numbered and may be used as a basis for recording the sales.
  - Repair order date - This may be the date that the vehicle is picked up by the customer. However, this date may vary depending upon when the repair order is prepared.
- **Customer authorization:** The customer will sign the repair order to begin the work. Note that several signatures may be required on the repair order depending upon whether the customer is also authorizing the body shop to sign or endorse any checks made payable to the customer.
    - Actual parts cost to repair the vehicle. These figures will usually be summaries of the parts purchases. Possibly, vendors and invoice numbers. In some cases, the net price (wholesale) and the list price (retail).
    - Sublet charges - Mechanical repairs, glass replacement, tire replacement, etc.
    - Labor charges - Repair Orders will usually list only the final totals and omit the actual hours worked or allowed.
    - Towing charges - Usually listed as a separate category.
    - Checks paid - Body shops will often record the payments received from the customers
    - (deductible payments) and insurance companies. Information will often include the specific number, the date of receipt of the check and the amount of the check. All needed to determine when to record the sale.
  - **Supplements:** Supplements can be written on estimate sheets, repair orders, sales invoices, or body shop correspondence. Essentially, supplements summarize the additional parts, sublet, and labor charges incurred after the original estimate approval. Supplements should have the following information:
    - Customer name and the date supplement was either written up or approved,
    - Vehicle description,
    - Insurance company authorization
    - Where the body shop has a good relationship with the insurance adjusters, only the shop owner's signature is required.
    - Note a different check than from the original insurance is used when supplements are paid. There may be a significant time lag between receipt of the original insurance check and the supplemental payment.
  - **Sales Invoices:** In some cases, a sales invoice may be prepared for the customer and all charges are recorded separately. For instance, parts, labor and sales taxes may appear as three separate items. Trace parts purchases and other costs from the vendor invoice to a specific job.

- **Parts Invoices:** These invoices are mentioned to point out that the parts costs are recorded at both wholesale and retail. It is important for the examiner to note these differences when inventory is an issue. Moreover, the determination of the discount received by the shop is important if he is planning to extrapolate inventory adjustments or parts revenue.

## G. The Mitchell Guides

- (1) The Mitchell Guides and Mitchell Software provide information that is one of the primary tools of the industry; so, the examiner should understand how the reference works. The Mitchell Guides are essential for both Auto Body Shops and insurance companies to prepare estimates in a quick and efficient manner.
- (2) The Guides are a series of volumes that contain pricing and repair information for automobiles. They are broken down into specific years and vehicle manufacturers. The specific title used by the auto body industry is the Collision Estimating Guide (Either Domestic or Foreign). Volumes and software undergo updates several times each year depending upon pricing changes.
- (3) The user is provided with general parts information such as illustrations, parts numbers, and whether interchangeable or discontinued. The Guide includes the cost of the parts at manufacturers' suggested retail prices at the date of publication.
- (4) Mitchell also supplies the suggested labor time (in tenths of an hour) it will take to replace a part. These times will be broken down into the complexity of the labor involved (that is, body, frame, paint etc.). Also provided are labor times for replacement of glass, application of stripes and decals, and for things such as sanding and grinding.

### G.1. Organization of Records

- (1) It is important to identify how the records are organized since the nature of the examiner's request will depend on the method used:
- (2) **Current Jobs:** Auto Body Shops usually maintain current jobs in folders (job jackets). The information contained will include the estimates for that job, the repair order, the dealer invoices for the parts, correspondence with the insurance companies, and the "flag sheets" which keep track of the number of labor hours spent on the job.
- (3) Usually the above information is kept together in one package by customer. This allows the shop to answer most questions that may arise regarding a completed job.
- (4) Sometimes the Auto Body Shop will separate the invoices by vendors. This is especially true where shops have established a credit line allowing one payment for all invoices accumulated during a month.

- (5) In smaller Auto Body Shops, it is not unusual for all information to be accumulated by the month. An envelope holding invoices paid and sales collected in a single month.

## H. Income

### H.1. Introduction

- (1) The repair process in an Auto Body Shop typically begins with the preparation of an estimate by the shop, either on the premises, or in the field if the car is not drivable. The estimate includes detailed categories of expense for labor, parts (at the retail list price), the cost of work to be done off the premises, and towing, if necessary.
- (2) If the owner of the vehicle is to bear the full expense of the repair and chooses to deal with the shop, the shop prepares a repair order reflecting the figures already on the estimate with any additions or deletions specified by the customer. The customer signs the repair order to authorize the indicated work.
- (3) If there is an insurer, they notify the company and dispatch an adjuster to the shop to make its own inspection and estimate of repair costs. This estimate is often lower than the one written by the shop because the insurer may not allow the full labor rate customarily billed and may eliminate part of the standard time to repair as duplication. For instance, the time required painting a fender and the adjacent door panel considered as less than the sum of the times needed to paint each § alone. Further reduction made for "betterments" and the cost to repair rather than replace parts or the use of "after- market" or used parts instead of new factory parts.
- (4) The cost of new auto body parts and the suggested installation time are listed in the Mitchell Guide, which is invariably used by both the shop and the insurance adjuster, but judgment about what needs to be replaced and what does not often lead to substantial variation in quoted and approved repair costs. The estimates in the example below illustrate the differences possible. The insurer's estimate shown is the final figure agreed to by the claimant. Note the areas of alteration from the initial offer below the chart.
- (5) To secure the work, body shops will generally accept insurance company rates, which can vary from company to company and by geographic area. They can negotiate with the adjuster on other points to obtain concessions. Once the insurance company has approved an estimate, work on the job can proceed and a repair order generated reflecting the approved amounts. Approval by the insurance company fixes the agreed upon amount and a check or draft is issued to cover their portion of the liability. In the case of collision, or a finding that both parties to an accident are at fault, the insurer's payment will be net of any deductible stated in the policy.
- (6) Some shops openly advertise that they will "save your deductible" and others will offer the option if pressed, or at least offer some concession, accomplished

by repairing versus replacing or by installing used or after-market parts instead of factory replacements.

- (7) Other shops will make no such arrangement and require full payment of any deductible on delivery of the completed job. This practice however, since it is common, opens a door to considerable abuse in reporting income when a deductible shown as waived in the accounting records was collected.
- (8) An interim step may be taken between the approved estimate and repair order and the completion of the job. If a complete tear down was not done before the estimate was made, previously hidden damage may surface once damaged parts are removed. Parts prices may also have increased since the last issued Mitchell Manual. When this occurs, the shop notifies the customer or his or her insurance company securing approval to perform additional repairs. If an insurance company is involved, the shop obtains approval by adjuster inspection of the damage or over the phone, particularly in the case of price increases. In either case, the insurer will issue a second supplemental payment and receipt of this payment, delayed to a length of time beyond both the originally approved charges and the completion of the work. Whereas supplements are not common, neither are they rare. There should be a new repair order written for the supplement, with payment separately accounted for, though occasionally the examiner may find only an addendum to the existing file.

**Example Illustrating the differences possible between the Auto Body Shop's and Insurer's Expenses:**

<b>Parts Expenses</b>	<b>Shop 1</b>	<b>Shop 2</b>	<b>Shop 3</b>	<b>Insurer</b>
Front Lamps Assembly	\$61.73	\$61.73	\$81.82	\$61.73
Front Fender	\$159.17	\$159.17	\$150.60	\$159.17
Front bumper cover	\$32.43	0	\$30.68	\$32.43
Splash Shield	\$29.95	0	0	\$33.85
Molding - protective	0	0	\$22.98	0
Front bumper cover	<u>0</u>	<u>0</u>	<u>\$219.05</u>	<u>\$231.53</u>
Parts Totals:	\$283.28	\$220.90	\$505.13	\$518.71



<b>Labor Expenses</b>	<b>Shop 1</b>	<b>Shop 2</b>	<b>Shop 3</b>	<b>Insurer</b>
<b>Sheet Metal:</b>				
Hours	8.1	15.3	17.0	8.0
Rate	\$28.00	\$28.00	\$28.00	\$26.00
Sheet Metal Total Labor	\$226.80	\$428.40	\$476.00	\$208.00
<b>Labor:</b>				
Refinish (Painting):				
Hours	4.4	12.3	11.0	5.9
Rate	\$28.00	\$28.00	\$28.00	\$26.00
Refinish Total Labor	\$123.20	\$344.40	\$308.00	\$153.40
<b>Labor:</b>				
Mechanic (Frame):				
Hours	0.0	1.5	1.0	1.0
Rate	\$-	\$45.00	\$45.00	\$35.00
Mechanic Total Labor	\$-	\$67.50	\$45.00	\$35.00
<b>Labor:</b>				
Sublet Expenses:				
Paint Materials	\$79.20	0	0	\$88.00
Cover Car	\$10.00	\$10.00	0	\$10.00
Wheel Alignment	\$65.00	0	0	0
Undercoat	\$8.00	0	0	0
Wash & Wax	0	\$25.00	0	0
Hazardous Waste Fees	0	0	\$26.80	0
Sublet Total Labor	\$162.20	\$35.00	\$26.80	\$98.00
<b>Total of all expenses:</b>				
	Shop 1	Shop 2	Shop 3	Insurer
Parts Totals:	\$283.28	\$220.90	\$505.13	\$518.71
Labor Totals:	\$512.20	\$875.30	\$855.80	\$494.40
Sales Tax:	\$31.39	\$36.49	\$45.70	\$50.92
Total of all costs	\$826.87	\$1,132.69	\$1,406.63	\$1,064.03

## H.2. Parts and Materials

- (1) Parts include any replacement to a vehicle component done by the shop. For a body shop, that usually means metal  $\S$ s, such as door skins and fenders,

headlights, bumpers and covers, skirts and trim. Anything more than the simplest mechanical, glass, tires and wheels, and upholstery work is generally sublet. Materials include the cost of paint materials, primer, and clear coat used to refinish a vehicle, separately shown on an estimate, and segregated on a repair order.

- (2) In a repair shop, parts include any mechanical replacement or betterment from water or fuel pumps and rebuilt engines, to spark plugs, glow plugs, and gaskets. Tires and batteries and accessories may also be included if the shop deals in them.

### **H.3. Labor**

- (1) A body shop breaks down labor by category since rates differ for each category of service, making a distinction between metal and less highly compensated paint or finishing labor. Frame labor, if not sublet, may also be stated separately and will command the highest hourly rate. In repair shops, a flat hourly rate for all services is the norm without the distinctions made in body shops even though the skill level required to perform different tasks varies.

### **H.4. Sublet**

- (1) Body shops sublet repair of glass, tire replacement and wheel balancing, radio and accessory replacement and repair, body striping and upholstery work, as well as most mechanical work. Repair shops sublet the preceding, except mechanical work, and most body and paint work.

### **H.5. Towing**

- (1) Towing is occasionally included in sublet accounts but usually listed separately. Facilities rebill the customer at cost or with a small markup for towing charges needed to deliver the vehicle to the repair shop billed to the facility. Significant payments to towing companies, especially a single company, can be a signal of an abusive practice in the auto body industry, explored in the Expenses § of this guide.

### **H.6. Storage**

- (1) While not usually a major source of income, all body shops will have some income from storage fees. Charges vary, but charged at a daily rate and arise when:
  - a car towed in for repair is totaled out but the insurance company does not promptly assess and remove the vehicle;
  - a car is left for an estimate and the owner declines to authorize repair or remove the vehicle;
  - a repaired vehicle is not picked up promptly after notification that the work is complete. In the last case, the usual charge levied is less and graces period, usually 3 days, allowed before fees billed.

## **H.7. Vehicle Sales**

- (1) Shops occasionally repair and resell damaged vehicles purchased from individuals, salvage yards, and auctions. Vehicles left for repair or estimate that and not claimed are subject to lien sale. The cost of filing varies for a company providing this service, depending on the value of the vehicle, and is recovered from the customer redeeming the vehicle prior to auction. It is possible to make a lien sale filing directly through the state department of motor vehicles. It is unusual to find more than a handful of lien sales filed during a year at a shop.

## **I. Other Income Sources**

### **I.1. Rebates and Refunds of Expense**

- (1) Car rental agencies may rebate a portion of the fees paid by the repair or body shop or customers referred by them. Agencies report insurance dividends and cancellation adjustments as an expense account reduction or as miscellaneous income, especially if applicable to a prior period expense.
- (2) Vendors issue checks for merchandise returns when the shop does not maintain an account. In some cases, the examiner will find refund checks issued for larger items even with an existing credit line. Reporting of these refunds as a credit to the expense account rather than income is common.

### **I.2. Supplemental Payments:**

- (1) The Auto Body Shop may record their sales based on the final repair orders that listed the income to due from the customer's insurance company. If supplemental work is required afterwards a separate repair order is prepared. During the last month of the year, the Auto Body Shop could record the initial income as stated on the original repair orders but would omit the supplemental payments. They would record those as income upon receipt of the supplemental payments. A comparison of the year ending cash receipts journal with the subsequent year's cash receipt journal often revealed the same customer names. Question the owner about the supplemental payments not recorded with the original repair order. The Auto Body Shop may respond that supplemental payments were uncertain of being paid. However, in many cases, the supplemental payments were almost 100 percent guaranteed of payment especially if an insurance company approved them in the first place. In this situation, the accrual basis Auto Body Shop should have recorded the entire sale since all work was completed. Although this is essentially a timing difference, this can result in a significant adjustment in the first taxable year corrected.

### **I.3. Other Sources**

- (1) Repair shops may also sell gasoline or issue smog certificates. Trace the number of certificates issued to any location.

## **J. Indications of Underreporting**

## J.1. Estimating Sales

- (1) In the auto repair business, there are some calculations that can be made to give an idea of the range of sales that should be expected given a claimed level of costs, if those costs are accurately categorized.
- (2) The average discount received on factory parts by body shops and the repair shops examined was 20 percent to 25 percent off retail. This is equivalent of a markup of 25 percent to 33.3 percent. Examination of purchase invoices from a cross section of suppliers used by a specific business will enable the use of a more accurate figure, but the preceding percentages will provide a ballpark estimate.
- (3) Parts other than factory parts, especially those purchased in bulk from large supply houses have a much higher markup, though the shop may not bill at the suggested retail as shown on the invoice. Markups can range over 100 percent on parts like water pumps and much more on smaller items like gaskets and filters. Obtain an average by inspecting the detail invoices from the suppliers used and repair orders.
- (4) In Auto Body Shops, management will try to keep labor costs down to 40 percent of labor sales, including any down time. Some shops pay wages based on this sales percentage. Some body shops may pay body men at a 50 percent rate during the time it treated them as "outside labor," but change to 40 percent when the status changes to that of employee. Double the labor costs to estimate labor income. If the owner works on the vehicles, consider the value of his or her labor for the labor costs reported in cost of sales. Using these figures from the return or the trial balance as a starting point, it is possible to determine a range of income expected. If the income reported is outside of this range, find out why. One reason is underreported income, but there are other reasons, some of which are:
  - The above percentages are invalid for this business, especially for labor.
  - Costs have been incorrectly categorized.
  - Some labor costs may be paid "off the books". This will make imputed income from labor lower.
  - There may be a large unreported inventory variance.
- (5) Once the examination is under way, categorize the direct expenses and refine the above percentages depending on costs at the shop under examination. If the calculations have been done correctly and there is still a significant difference between what expected sales should be and what was reported, an attempt to reinforce the findings using another method or consideration of another factor should be made.

## **J.2. Repair Orders**

- (1) These are usually numbered and used consecutively just like checks in a checkbook. Having asked earlier what is done with voided orders and how many are voided, ask for the voided orders if they are retained and set up a series of work papers to cover all the numbers of the earliest through the final repair orders reported for a quarter or the year. The numbers of the orders included in sales can be marked and any gaps will become apparent. Voided orders may account for some of the skipped numbers not supplied, but this should not be a substantial amount. At the beginning and the end of a period, work may have been completed in the prior period or remain in process until the subsequent period. After consideration of these factors, substantial numbers of invoices missing from the sequence can be another indication of unreported amounts. This cannot show unreported amounts, but unexplained missing repair orders may account for the difference between the estimate of expected income and the amount reported.
- (2) Conversely, if there are no gaps in the reported repair order sequence, it does not necessarily confirm that no sale went unreported. If repair orders are not numbered, a schedule of the number written by date may provide indications of omission, especially in a repair shop.

## **K. Other Income Issues**

### **K.1. Waived Deductibles**

- (1) As stated earlier, saving or waiving a deductible in whole or part, to attract business is common among Auto Body Shops, accomplished by repairing rather than replacing a part or substituting used or after-market parts for factory parts or just by shaving the profit margin in some cases. The repair order may echo the insurance estimate, with the deductible marked "waived" and the sale entered the sales journal at net, or the waived portion accounted for as customer allowances or concessions.
- (2) An insured collision repair is payable in two parts, the insurance company's check or draft and the insured's deductible payment. If a fully waived copayment, the insurance payment is payment in full and either method of accounting for the income outlined is an accurate representation. With repair costs fully paid in the usual manner and the deductible shown waived only on the accounting records, considerable income can be unreported.
- (3) If the examiner repeatedly sees deductibles waived and it is suspected that they have been collected, consider third party contact procedures with some of the customers facilitated by the phone numbers customarily included on all repair orders.

### **K.2. Cash Payments**

- (1) Most customers pay by check or credit card. Check the detailed duplicate deposit slips usually attached to the appropriate repair orders. The duplicate

deposit slips correspond to the bank deposits shown on the statements, though the posting date often delayed. Many body shops insist on payment by a certified or cashier's check, or cash.

## **L. Cost of Sales**

### **L.1. Introduction**

- (1) Cost of sales for an auto body business will be the largest category of costs shown on the return. Because of the large dollar amount relative to the other expenses, cost of sales warrants special attention. It encompasses at least three major costs categories:
  - Purchases
  - Labor
  - Sublet Expenses
- (2) It may also include inventory totals for the beginning and ending of the year.

### **L.2. Purchases**

- (1) The major cost associated with the purchases account will be for parts used in the replacement or repair process, acquired new from auto dealers or parts stores, or used from auto dismantling businesses. In some cases, they purchase entire automobiles for the sole purpose of obtaining parts. Depending upon the services provided by the body shop, parts may include items such as panels, doors, bumpers, fenders, hoods, etc. as well as minor engine parts such as water pumps, radiators, etc. Purchases accounts also include the cost of materials used to restore the vehicle to its original state upon replacing or repairing the parts. This category includes bond, primers, thinners, paints, sandpaper, etc., often purchased from businesses that specialize in automotive paints. Since insurance companies pay for most of jobs, the amount the Auto Body Shop will eventually receive for the repair of a vehicle will be determined before the start of the job. Insurance companies allow retail list price for parts, paint, supplies, and other items. Vendors will normally provide discounts to Auto Body Shops ranging from 15 to 40 percent of the retail price. If an Auto Body Shop can purchase so-called "after-market" parts (which are usually encouraged by insurance companies), the discounts will range even higher resulting in greater profits for the body shops. Parts purchased locally are deliverable in a matter of days or even hours. However, in some cases, parts needed from overseas factories, which can result in delays of several weeks or even months. If no longer manufactured, the Auto Body Shop may have to search the various dismantling businesses to find a part. Some fabricate parts for high end or classic vehicles.

## **M. Records to Request and Examine:**

## **M.1. General Records**

- (1) The following records should be requested and examined when applicable:
  - General Ledger
  - Disbursements and/or payables journals
  - Journal entries or accruals
  - Original Estimates - these documents may be prepared by the Auto Body Shop or by the insurance companies. The estimate is their authorization and agreement to pay. They also provide the "expected" parts, supplies, and labor costs needed to complete the job based on the Mitchell Collision Guides or the insurance companies own in-house pricing systems. The actual prices paid by the Auto Body Shop may differ depending upon whether original factory parts, "after- market" parts or used parts are installed. Once approved the estimate total costs should agree with the total costs shown on the repair order.
  - Repair Orders - This document should have the customer's authorization to begin the job. It can also provide other important information such as the customer's name and phone number, date a job was started, itemized listing of parts, supplies, labor, sublet expenses incurred at retail or wholesale, make, year, model of the vehicle, and the date of payment. It provides a useful summary of costs for each job.
  - Vendor Invoices - These invoices will list the parts prices at retail and wholesale. This allows an examiner to compute the discount provided to the auto body shop for inventory and income probe purposes. Since many body shops can purchase parts on credit, individual invoices may be collectively paid in one lump sum at the end of the month and may be accompanied by a summary statement. Information that may prove useful is that these invoices will often list the model and year of the vehicle that is associated with the parts purchased.

## **M.2. Purchases Audit Procedures**

- (1) The Auto Body Shop's method of filing their records may require modification of the examiner's transaction selection process. Because these situations may arise, we mention them here:
- (2) Source documents maintained by customers. In this situation, the Auto Body Shop will maintain all source documents estimates, repair orders, vendor invoices, and sales invoices by customer. This type of arrangement makes transaction selection from the general ledger or disbursements journals difficult since vendor invoices, which pertain to several customers may comprise a single transaction in the general ledger. Encountering this type of arrangement, make the transaction selection from the sales journals in conjunction with the income test work. Note however, that this type of arrangement makes the inventory test work easier.

- (3) Purchase invoices maintained by vendors. This is the "standard" situation encountered. This arrangement allows the examiner to trace entries made into the purchases account directly to specific source documents. However, customers may still file repair orders and estimates. In contrast to the preceding situation, inventory test work is more difficult.
- (4) Source documentation filed by month, (commonly encountered with smaller businesses.) The estimates, repair orders, vendor invoices, and sales invoices filed by the month that the transaction was paid, or monies received. Note that to test the accruals, the examiner needs to reference the subsequent year's first month documentation.

### **M.3. Labor**

- (1) The labor involved in restoring a vehicle to its original state after a collision can be quite extensive. If the damage to the vehicle is limited to its exterior, then the replacement of a part can continue quite quickly with very few hours or even segments of an hour. However, when dealing with a damaged frame then the amount of labor involved can escalate. Usually labor is broken down into several primary categories, paid either by the hour or on commission. The commission may be a percentage of the allowable amount determined by the insurance companies.

### **M.4. Sheet Metal Labor**

- (1) Sheet metal work usually involves the process of replacement or the repair of a part if possible, by straightening, pounding, or a combination of both.

### **M.5. Frame Labor**

- (1) Frame labor is the most highly skilled and compensated of the total labor involved. Special equipment and skills are needed to correctly straighten or correct a frame. The work involves continuous alignment of points on a vehicle so that it rides as it did in its pre-damaged state.

### **M.6. Paint Labor**

- (1) Painting or finishing may or may not be a separate labor category since some Auto Body Shops have body workers who also act as paint personnel. In most cases, however, the paint labor will be separate. In situations where the Auto Body Shop has its own paint mixing system, the personnel in charge must be able to mix paint, toners, and thinners to match the original paint of the vehicle. In some cases, the personnel must be skilled in the art of "blending" which means gradually lightening or darkening the mixed paint so that any mismatching due to fading in the original paint is not so striking. Paint labor also involves the actual sandpapering, wet blocking, application of the bond, and the eventual spraying. This is the least skilled and compensated of the labor involved.



## **M.7. Minor Mechanical Repairs**

- (1) Some body shops will do minor mechanical and electrical work. This will involve replacement of water pumps, radiators, lights, etc.

## **M.8. Labor Audit Procedures**

- (1) Because of the rise in labor related costs such as worker's compensation, health insurance, and employment taxes, some Auto Body Shops treat all or part of their labor force as independent contractors. To determine whether individuals are employees or independent contractors discuss the issue with an Employment Tax Specialist. The examiner should be aware of certain signs that may indicate an employment tax issue.
- (2) During pre-audit of the return, compare the employment tax deduction with the respective labor, wages, and salaries. Therefore, an estimate (restricting officer's salary to FICA maximum if it is large and the shop is small) of the wages should give a rough approximation of the true employment taxes. For computational purposes, the examiner can assume that all wages are subject to FICA but no more than one-half subject to unemployment taxes.
- (3) Package Audit Steps - This includes a reconciliation of the wages per the books to the employment tax returns. This reconciliation may highlight labor deductions that do not hit the employment tax returns. Another suggestion is the comparison of the employment tax returns associated with the year of audit to the subsequent returns filed up to the current year. Some Auto Body Shops convert their "independent contractors" to employees when they move locations, highlighted by a sudden jump in wages and employment taxes. The reverse may also be true if employees are reclassified as "independent contractors".
- (4) The examiner should inspect the general ledger for a breakdown of the various labor costs being booked. The source of the entries should be some sort of payroll register. If the entries are flowing directly from a cash disbursements journal, this may indicate straight disbursements without withholding.
- (5) Examine the Form 1099 statements issued by the Auto Body Shop. For example, if the Form 1099 statements were made out to "A...s Auto body" or "B...s Auto body", consider them unusual since Auto Body Shops normally do not subcontract work out to other Auto Body Shops.
- (6) During the walk-through of the place of business, notice if the personnel working in the paint department, frame area, or repair area, are wearing uniforms with the Auto Body Shop's business name on them. This indicates that they are employees of the Auto Body Shop. Then check the employment tax records to see their classification.

## **M.9. Sublet Expenses**

- (1) Sublet expenses are those costs incurred for services and supplies that are not normally, provided by the Auto Body Shop either because the shop is not

equipped to handle them, or the cost would be prohibitive. As with the parts, insurance companies allocate reimbursement based on Mitchell Guides or their own in-house studies.

(2) Some common sublet expenses are:

- tire replacement - If a vehicle's tires were damaged then the body shop will sublet the vehicle out for replacement and wheel alignment.
- window replacement - replacement of glass or mirrors and tinting.
- detailing - involves car washes, waxes, cleaning of the vehicle, and "scenting" the interior.
- pin striping - involves specialized painting or application of decals to the vehicle for enhancement purposes.
- upholstery work - replacement or recovering of seats.
- mechanical repairs - involves any major mechanical work which is not performed by the body shop.

(3) Many other costs may be classified as sublet depending upon the accounting organization of the Auto Body Shop. The purpose here is to make the examiner aware of the different type of costs incurred by the Auto Body Shop.

## **N. Expenses**

### **N.1. Uniforms**

(1) Occasionally an employer will buy uniforms or T-shirts for use by his or her employees. More often, however, a service will be used to supply and clean uniforms, cloths, and towels. Inspection of the invoices can show the quantity supplied on a regular basis and infer the number of persons working on the premises. Some shops withhold a moderate uniform charge from compensation paid with the withheld amounts generally offsetting the expense account. Such withholding indicates work performed on the premises and a degree of control exercised by the employer.

### **N.2. Other Investments Account of the 1120 Balance Sheet.**

(1) For example, the ending balance sheet of a corporate Auto Body Shop for the 2006 tax year listed the Investment Account balance as \$190,000. However, the beginning balance in the Account for the 2007 tax year listed the amount as \$30,000, a difference of \$160,000. The examiner determined that this difference was due to three classic automobiles held for investment at the end of 2006 taken off the corporate balance sheet and transferred to the shareholder. The assets removed because the sale of the company was in the process and the shareholder wanted the assets for his personal investment. Corporate costs were involved in the restoration of these classic automobiles.

### **N.3. Non-cleared Checks**

- (1) Examinations of the bank reconciliations at the end of the year will allow the examiner to determine if some checks are still outstanding after a substantial amount of time has passed since originally issued. This is especially prevalent with payroll checks never cashed or deposited by the payee.

### **O. Other Receivables**

- (1) An examination of the employee advances account may reveal that the corporation cleared out these advances by forgiving the debt and booking the amount as an employee bonus at the end of the year. This amount appeared as a deduction in the salaries account but never recorded as far as employment taxes and Form W-2 wages were concerned. Sometimes employee advances transfer to salaries and wages, never accounted for on the employment tax returns.

### **O.1. Automobile Rental**

- (1) Rebates on auto rentals are one practice an examiner may see at body shops and, to a lesser degree, repair shops. For example, payment made to the business by the rental company based on the volume of business placed with them. It was not necessary that the shop supply the rental car to the customer, only that they refer the business to the rental company. When the body or repair shop did incur the expense, however, they were likely to credit the expense account with the rebated amounts. A lack of such an offset to a car rental expense account would be unusual, though the amounts involved are generally nominal.

### **O.2. Finders or Referral Fees**

- (1) Referred to as "bird dog" fees they are payments to individuals by body shops for referring customers to the shop. This is illegal in some states and not allowed under the insurance laws if the individual receiving the payment is an independent adjuster, insurance agent, or broker. The finder's fees range from \$50 to \$500 per vehicle. The fees tend to mount up over the course of a year and sometimes body shops fail to comply with Form 1099 filing requirements. Both the Form 1099 penalties and backup withholding are appropriate in such a case.

### **O.3. Lien Sale Filings**

- (1) Shops file notice of lien sales for work done or storage charges on vehicles not retrieved at a repair or body shop or a towing service, for unpaid charges. Properly notifying the owners, they may redeem their property by satisfying the debt plus filing costs prior to lien sale.
- (2) Commonly employed is a lien sale service to process the paperwork. This sale service charges varying fees depending on the value of the vehicle. Recovery income would be anything over the amount charged.

## O.4. Towing Service Payments

- (1) Tow truck operators sometimes receive payments to deliver wrecked vehicles to a body shop. These payments are in addition to normal towing charges and not made directly. An example of indirect payment Indirect payment could be made indirectly by allowing the towing service to operate their business rent free using a portion of their leased premises and one of the two addresses assigned to the property.

## O.5. Insurance Fraud

- (1) Insurance and consumer fraud receive a great deal of media attention. If the Auto Body Shop being examined reports an extremely high profit margin on parts, but the inspection of the purchase invoices from its suppliers indicate that the shop received only the usual 20 to 25 percent discount, they could be billing for parts that were neither required nor replaced. Although the shop appears to have reported the profits, an understatement of parts sales revenues would not have been easily detected based on costs.

## O.6. Smog Certificate Sales

- (1) This issue involves selling the smog certificates at a premium price without any inspection of the vehicle. It is even possible to purchase a certificate for a purely fictitious automobile. The fee charged for this kind of "service" is higher than the cost of a legitimate inspection, but less than the cost of bringing many vehicles into a state of compliance.

## P. Glossary

- (1) **Adjuster** - Individual qualified in performing estimates and appraisals. This individual may be an insurance company representative or an individual who works for an independent appraisal company.
- (2) **“After-Market” Parts** - Discount parts that copied from factory original parts. These parts are of lower quality but may be lower in price by as much as one-third the original part's price.
- (3) **Betterment** - Term used to describe additional benefit, which may accrue to the party whose owns the repaired vehicle. For instance, a tire may need replacement, but at the time of the accident, the wear and tear had only reached a certain percent. The insurance company may decide that they are only responsible for that certain percent of the replacement cost. Another example is with an upgrade in equipment such as a radio. If the customer is obtaining a higher quality radio than the damaged one; the insurance company may only cover the cost of the damaged radio.
- (4) **Blending** – The gradual lightening or darkening of paint on a repaired vehicle to eliminate spottiness.
- (5) **Bondo** - Compound applied to the vehicle to smooth out and fill the exterior so that paint may be applied.

- (6) **Claimants** -Term used to describe third parties responsible for handling the damage payments. For instance, when individual B damages individual A's vehicle, if individual B's insurance company were responsible for the payments to the Auto Body Shop, then individual B would be the claimant. In other situations, this also describes the individual making the claim.
- (7) **Clear Coat** - Finish added after paint job to give the vehicle a high luster look and protection.
- (8) **Criteria Sheet** - Agreement form between the Auto Body Shop and insurance company. Items listed will be use of "after-market" parts, overlap systems, etc.
- (9) **Deductible (Insurance Policy)** - The portion of the repair cost for which the customer is personally responsible.
- (10)**Detailing** - Enhancement after body repair by washing, waxing, interior cleaning, shampoo treatments, etc.
- (11)**Direct Repair Program** - (DRP Shops) Program where insurance companies contract with certain body shops and agree to send work to those shops in exchange for the body shop using "after-market" parts and giving cost reductions on certain types of labor.
- (12)**Drive-in Claim Center** - Concept where the customer drives their vehicle to the insurance company to have an estimate performed.
- (13)**Estimate** - Process whereby the insurance company or the Auto Body Shop projects the cost of the parts, labor, and other supplies needed to repair a vehicle. Projections based on previous studies done under optimum conditions.
- (14)**EZ Liner** - Trade name of the most common type of frame straightener. Attaching the vehicle to this workbench the technicians line up certain points on the frame and the vehicle is then "pulled" until the frame is straight.
- (15)**Flag Sheet** - Sheet used by auto body employees to record the number of hours spent on a specific vehicle.
- (16)**Frame** - The body components bolt or attach to the frame. This differs from unibody construction where the components act as a frame.
- (17)**Hidden Damage** - Additional damage not discovered during the teardown and not approved in original repair order. Usually found during later stages of repair. These damages require separate approval for repair.
- (18)**Insured** - Term used to describe the individual owning the damaged vehicle. The individual's insurance company would be responsible for submitting the final payment to the Auto Body Shop.
- (19)**Job Jackets** - Folders used to keep paperwork together for current and on-going jobs.
- (20)**Mask** - Bumper Cover.

- (21) **Masking** - Protection of glass, chrome, and other parts during the vehicle painting.
- (22) **Mechanics Lien** - A filing with the State Department of Motor Vehicles (or similar agency) on vehicles with unpaid charges for repairs and/or storage. If the delinquent amounts are left unsettled within legally prescribed periods, allows for the vehicle's sale in satisfaction of the debt.
- (23) **Mitchell Guides** - Set of guides that contain the suggested retail and wholesale prices for parts and the suggested labor and paint hours needed to install and paint the various parts. These guides may be in book form or computer software.
- (24) **Overlap** - Concept used by insurance companies to designate common times used to repair a vehicle. For instance, assume the Mitchell Guide states that it takes 8 hours to remove a § of a vehicle to work on parts A, B, and C. It then takes 6 hours to replace part A, 2 hours to remove part B, and 2 hours to remove part C. This results in reduction by 2 hours in the time to remove part B and part C because theoretically, the § removal needed to work on the parts is only required once.
- (25) **Overspray** - The spray or mist of paint or primer that settles on parts of the vehicle other than those intended.
- (26) **Panels** - General term to describe body components. Also described as side panels, quarter panels, etc.
- (27) **Pin Striping** - Specialized painting or decaling.
- (28) **Primers** - Chemicals used to coat the metal surface of the vehicle to avoid rust and to fill in scratches.
- (29) **Repair Order** – A document that usually contains the charges for parts, labor, and other costs. The customer approves this before performance of actual work on the vehicle.
- (30) **Replacement Repair** – When damaged body parts are beyond repair, they need replacement. Repair work includes framework repairs. Replacement work costs can generally be obtained from the various pricing guides. These repair work costs are negotiable between the shop and insurance company or customer.
- (31) **Restoration** - Process used for classic, expensive, and antique automobiles whereby the vehicle is restored to its original condition or even better. Restorations involve many services including high quality paint jobs, major engine and transmission replacement, and body parts fabrication.
- (32) **Shroud** - Cover for many parts - for example, radiator shroud.
- (33) **Skin** – otherwise referred to as "door skin" is the visible metal covering a constructed component.

- (34) **Sublet Expenses** - Generic term used to describe services not ordinarily performed by the Auto Body Shop. These services include services like upholstery work, radiator repair, tire replacement, etc.
- (35) **Supplemental Payments** - Payments issued by insurance companies that account for additional damage not spotted during the initial estimate. May also cover price increases of parts not yet updated in the Mitchell Guides. Supplemental payments commonly issued separately after the regular payment.
- (36) **Tear Down** - Removal of surface damage to assess total repair needed.
- (37) **Undercoat** - Coating given to the bottom of the vehicle to protect from rust and corrosion.
- (38) **Unibody Construction** - Concept where the body parts act as the frame of the vehicle. The parts support the weight of the vehicle. Bonded rather than bolted together construction.
- (39) **Warranty Work** - Additional work performed after the job has been completed and paid for. In this situation, the Auto Body Shop is responsible for the additional costs.
- (40) **Wet blocking** - Sanding done after primer is applied so that paint can be applied.

## X. Chapter 10: Direct Sellers

### A. Introduction

- (1) Direct selling provides important benefits to individuals who desire an opportunity to earn an income and build a business of their own; to consumers who enjoy an alternative to shopping centers, department stores or the like; and to the consumer products market. It offers an alternative to traditional employment for those who desire a flexible income earning opportunity to supplement their household income, or whose responsibilities or circumstances do not allow for regular part-time or full-time employment.
- (2) The cost for an individual to start an independent direct selling business is typically very low (which is a major selling point for entering this type of self-employment business). Usually, a modestly priced sales kit is all that is required for one to get started, and there may be little or no required inventory or other cash commitments to begin. This stands in sharp contrast to franchise and other business investment opportunities that may require substantial expenditures and expose the investor to a significant risk of loss. Direct selling companies market their products through person to person contact away from a fixed retail location through a network of independent sellers. Frequently these sales presentations are in the home; in the form of a sales “party,” or through door to door solicitations, or sometimes, as part of a get-together – one person to one person. In any case, these approaches are all considered direct sales. In addition, direct selling provides a channel of distribution for companies with innovative or distinctive products not readily available in traditional retail stores,

or who cannot afford to compete with the enormous advertising and promotion costs associated with gaining space on retail shelves.

- (3) This selling method should not be confused with terms such as direct marketing or distance selling which may be described as an interactive system of marketing that uses one or more advertising media to affect a measurable response and/or transaction at any location, with this activity being stored on a database. Some commonly known types of direct marketing and distance selling techniques are telemarketing, direct mail, and direct response. Direct selling is sharply contrasted to this type of sales as it concentrates on face to face or personal presentation which is always an aspect of their selling relationship.

## **B. Types of Direct Selling Companies**

- (1) There are two types of direct selling companies – single level marketing (SLM) or multilevel marketing (MLM). SLM companies reward direct sellers for their own personal sales activity. SLM direct sellers cannot take on other distributors or sales representatives. Income comes from commission or bonus on sales.
- (2) In an MLM, sales representatives can sponsor other distributors or sales representatives and receive a commission or bonus on the sales made by their underlying resellers. This recruitment of down liners is necessary to increase a sales representative's sales force and thus generate a greater number of sales. MLMs are often referred to as network marketing companies.
- (3) Multi-level marketing differs from an activity called a "pyramid scheme." Pyramid schemes are illegal scams in which large numbers of people at the bottom of the pyramid pay money to a few people at the top. The success of a pyramid scheme relies upon a never-ending supply of new participants.
- (4) While pyramid schemes seek to make money quickly, MLM companies seek to make money with their representatives as the business grows by selling their consumer products. MLM companies have a start-up fee that is small with a starting sales kit being sold at or below the company's costs. MLM depends upon sales to the consumer and establishing a market.

## **C. Demographics of Direct Sellers**

- (1) Direct selling is a rapidly growing industry. U The majority of direct sellers are independent businesspeople; they are micro-entrepreneurs whose purpose is to sell the product and/or services of the company they voluntarily choose to represent - not employees of the company. Why are Americans so interested in becoming direct sellers? Since most are independent contractors, they can work part-time or full-time and can choose when and how many hours they want to devote to their business. In other words, an individual can earn in proportion to their efforts. The level of success is limited only by their willingness to work hard. And a person can own their own business with very little or no capital investment.



- (2) Since direct sellers do not need any specific amount of education, knowledge, or any specific requirement to be successful, they only need the desire and self-motivation to grow their business and make it profitable for them.
- (3) It is impossible to estimate the number of direct selling companies operating at any given moment. This is a result of several different factors. First, most states do not require direct selling companies to register as such. Second, as with any business, many direct selling companies do not thrive in the direct selling market and have a relatively short life span.

### **C.1. NAICS Codes and the Direct Selling Industry**

- (1) The North American Industry Classification System (NAICS) groups the economy into 20 broad sectors. The Code 44-45 is specifically for the Retail Trade sector.
- (2) The NAICS definition emphasizes what the establishment does, rather than to whom it sells. Retailers are defined as those establishments that sell merchandise, generally without transformation, and attract customers using methods such as advertising, point-of-sale location, and display of merchandise. A store retailer has a selling place open to the public; merchandise on display or available through salesclerks; facilities for making cash or credit card transactions; and services provided to retail customers.
- (3) Taxpayers are instructed to enter on the Schedule C or Schedule C-EZ the NAICS code which best describes the type of business activity that they participate in.
- (4) The instructions to Schedule C list several NAICS codes relating to non-store retailers. As discussed in this audit technique guide, NAICS #454390 is probably the most appropriate code for direct selling businesses.
- (5) NAICS #454390 – Other Direct Selling Establishments (Including Door-to-Door Retailing, Frozen Food Plan Providers, Party Plan Merchandisers, and Coffee-Break Service Providers). These establishments are primarily engaged in retailing merchandise (except food for immediate consumption and fuel) via direct sale to the customer by means such as in-house sales (i.e., party plan merchandising), truck or wagon sales, and portable stalls (i.e., street vendors).

#### **Examples:**

- Direct selling bottled water providers
- Direct selling coffee-break service providers
- Direct selling frozen food and freezer plan providers
- Direct selling home delivery newspaper routes
- Direct selling locker meat providers
- Direct selling party plan merchandisers

## C.2. Industry Organizations:

- Direct Selling Association [www.dsa.org](http://www.dsa.org)
- World Federation of Direct Selling Associations [www.wfdsa.org](http://www.wfdsa.org)
- Direct Selling Education Foundation [www.dsef.org](http://www.dsef.org)

## D. Income Issues

### D.1. Gross Receipts

- (1) A direct seller prides himself in naming his own hours and has the luxury of deciding how much or how little time is spent on running the business. Typically, direct sellers spend time on the following activities:
  - Product or service sales
  - Administration and paperwork
  - Recruiting or sponsoring others
  - Training someone else or receiving training themselves
  - Miscellaneous other duties.
- (2) A direct seller may spend more or less time on each activity depending upon where the seller is in developing the business and whether the seller is engaged in a single or multi-level effort.
- (3) To know how much commission a direct seller is earning we must know when the direct seller is eligible for a commission. Each company has its own specific method of determining commissions. Some examples of when commissions are paid include:
  - At the time the order is placed with the company for shipment,
  - At a later specified date, even though the customer pays the full merchandise price upfront, and
  - A portion of the commission is paid upfront, and the remainder paid at a later specified date.
- (4) There are two ways that a direct seller can earn income/profits: They can sell the product and they can sponsor/recruit new representatives. Each company has its own set percentage of commission on direct sales, as well as additional percentages of additional income from their "down-line" sales. These percentages are generally smaller but are based on sales produced by that recruit.

### Example

- (5) A direct salesperson/consultant would receive a 25% commission on personal sales. Once they sponsor/recruit two new consultants, they receive an additional 2% of the recruits' sales each month. If they sponsor/recruit four to

six new consultants, this percentage increases to 7%. Both the original consultant and the recruits start earning additional income. In addition, if one of their recruit's sponsors two new consultants, they can earn 4% of the sales of those new recruits.

- (6) In addition to the base commission and the additional commission earned on a down-line, there is an added benefit of personal discounts.
- (7) All income that is received from direct sales is taxable under IRC § 61 and should be reported as gross receipts. There is a misconception that if the income is not reported on Form 1099-MISC, it is not taxable. Direct sellers may receive income in several different forms, including:
  - Income from sales - these are payments received from their customers for product purchases.
  - Commissions, bonuses, or percentages of income received because of sales from others who work under them (commonly referred to as their "down-line").
  - Prizes and awards received from the selling business, taxable under IRC § 74.
  - Income also includes products received as a result of meeting certain sales quotas (for example, receiving all products displayed on the front page of the new catalogue in exchange for selling at a certain level for that month).
  - Typically, the hostess, not the direct seller, receives gifts. However, gifts **received by the** direct seller are considered payments to help the direct seller make sales. The fair market value of these gifts must be reported as income under IRC § 61.

## D.2. Form 1099-MISC

- (1) IRC § 6041A (b) and Treas. Reg. § 1.6041A-1(b) require information reporting on Form 1099-MISC if:
  - any person engaged in a trade or business during any calendar year sells consumer products to any buyer on a buy-sell, deposit-commission, or other commission basis for resale (by the buyer or any other person) in the home or otherwise than in a permanent retail establishment, and
  - the aggregate amount of the such sales made by such person to such buyer during such calendar year is \$5,000 or more.
- (2) A person is considered to sell a product to a buyer for resale even though the buyer does not acquire title to the product prior to selling it to the consumer. For example, a person paid on a commission basis who does not acquire title to a product before selling it to the consumer is considered to have bought the product for resale for purposes of IRC § 6041A(b).

- (3) In the direct selling industry, gross receipts are generally based on “commissionable sales.” Commissionable sales are retail sales of products for which the sales representative earns a commission. Sales may include items that are sold specifically on a non-profit basis, whether for a charitable purpose or as a reward for hitting a certain pre-set sales figure per customer.

### **Example**

- (4) A customer who purchases a minimum of \$30 worth of retail products receives the opportunity to purchase a specific item at a special sales price of \$6.75. The sales representative earns a base commission on the \$30.00 retail sale but does not earn anything on the special sales price item. This is used as a “carrot” to entice customers to purchase enough to receive the opportunity to purchase the special sales price item.
- (5) It is important to remember that compensation in a direct seller marketing plan is derived primarily from the sale of consumer products to ultimate consumers and users. Ultimate consumers include those direct sellers who purchase products for their personal, family, or household use. No compensation is earned merely from the act of recruiting additional participants to the plan.

## **E. Expense Issues**

### **E.1. Start-Up Expenses**

- (1) The costs of getting started in a business, before the direct seller is authorized to start selling products, are capital expenses. These start-up expenses include the cost of exploring different direct-selling opportunities; the cost of any training the direct seller must have before becoming a direct seller for their product line, any fees that must be paid to the company to become a direct seller, and similar costs.
- (2) Start-up expenses in direct selling companies include the cost of a starter kit purchased directly from the company. The starter kit may include optional products that are part of the sales display; conceivably, the products could be sold to a customer.
- (3) Some tax issues raised include:
- starter kit - how does the direct seller account for the cost of the kit and related items?
  - discontinued display items - when products become obsolete (discontinued) where do they go? Are they sold at a discount, converted to personal use, or given away as a gift?
  - other income - for items taken out of the kit and/or inventory and disposed of by sale, where income is reported, and was fair market value or adjusted basis used to calculate income? If converted to personal use or given away as a gift, how is this reported on the books?

- (4) We need to consider whether expenses are start-up expenditures under IRC § 195 or inventory and/or cost of goods sold under IRC § 471. Let's first consider start-up expenditures.

## E.2. IRC § 195

- (1) IRC § 195(c) (1) defines the term "start-up expenditure" to mean any amount:
- paid or incurred in connection with investigating the creation or acquisition of an active trade or business, or
  - creating an active trade or business, or
  - any activity engaged in for profit for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business, and which, if paid or incurred in connection with the operation of an existing active trade or business, would be allowable as a deduction for the taxable year in which paid or incurred.
- (2) IRC § 195(a) provides that start-up expenditures generally may not be deducted. However, a taxpayer may elect to deduct certain start-up expenditures. For amounts paid or incurred after October 22, 2004 (the date of enactment of the American Jobs Creation Act of 2004), IRC § 195(b) (1) provides that if a taxpayer makes an election:
- the taxpayer can deduct, for the taxable year in which the active trade or business begins, an amount equal to the lesser of –
    - the amount of start-up expenditures, or
    - \$5,000, reduced by the amount by which the start-up expenditures exceed \$50,000, and
    - the remainder of the start-up expenditures may be deducted ratably over the 180-month period beginning with the month in which the active trade or business begins.
- (3) For trades or businesses beginning business in 2010, the taxpayer can deduct, for 2010 the lesser of –
- the amount of start-up expenditures, or
  - \$10,000, reduced by the amount by which the start-up expenditures exceed \$60,000, and
  - the remainder of the start-up expenditures may be deducted ratably over the 180-month period beginning with the month in which the active trade or business begins.
- (4) An election under IRC § 195(b)(1) must be made no later than the due date (including extensions) for filing the return for the taxable year in which the trade or business begins. The election is made by attaching a statement to the taxpayer's return.

- (5) If the taxpayer completely disposes of a trade or business before the end of the period over which the start-up expenditures are being deducted ratably, any expenditures that have not yet been deducted may be deducted to the extent allowed under IRC § 165.

### **E.3. Inventory and Cost of Goods Sold**

- (1) See the books on the Inventory and IRC 263A shelf within the Corporate/Business Issues and Credits Knowledge base in the Servicewide Virtual Library.
- (2) Per Treas. Reg. § 1.471-1, to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser.
- (3) What if the direct seller keeps the company's products on hand to show to potential customers? Is the cost of purchase part of the cost of goods sold, a capital expense, a business expense or a personal expense? It all depends on the circumstances at the time of purchase. However, the cost of a product that is used by the direct seller is a personal expense, even if that product is occasionally shown to prospective customers. Some direct sellers erroneously think they can decorate their home with products and deduct the cost as a business expense. To be deductible under IRC § 162, the expense must be an ordinary and necessary expense paid or incurred in carrying on a trade or business (also see Treas. Reg. § 1.162-3). Under IRC § 262, no deduction generally is allowed for personal, living, or family expenses.

#### **Example 1**

- (4) York is a direct seller who uses many of the products in her own home. When potential customers come to her house, she can show them drapes she bought from the company, as well as her lawn chairs, toaster, grill, tea set and spice cabinet. By showing these items in her own home, she hopes to interest people in buying them from her company or in becoming a direct seller themselves. York cannot take a deduction for the cost of any of these products. Because she uses them in her own home for personal reasons, their cost is not a cost of doing business.
- (5) If the direct seller has a product that is used as a demonstrator for one year or less and that demonstrator itself is not available for purchase by the direct seller's customers, its cost is considered a business expense. However, if the demonstrator is available for purchase by a customer, then it is to be considered part of the direct seller's inventory.

## **Example 2**

- (6) Lucida is a direct seller of kitchenware. Customers must order items from a catalog, but she keeps at least one of each type on hand to show buyers. When her product line changes and items are discontinued, she either starts using the demonstrator in her own kitchen or tries to sell it. When she had a garage sale, she sold many unused demonstrators. Lucida includes her demonstrators, including those for discontinued products, in her inventory of goods for sale. When she sells a demonstrator, including those she sold at the garage sale, she includes the income in her gross business receipts. When Lucida starts using a demonstrator in her own kitchen, it is a withdrawal of inventory for personal use. She subtracts the cost of the item from her purchases for the year. If Lucida qualifies under the small business exception for inventory, then that item is to be removed from her list of items available for sale (or whatever method she uses to track the items to be expensed once they are sold) and the cost of that item can NEVER be used as a business expense.

### **E.4. Other Expenses that Direct Sellers May Deduct**

- (1) Direct sellers may claim deductions on a portion of their cell phone costs, magazine subscriptions, meals and entertainment, mileage or vehicle expenses, home office expenses and compensation of children or relatives.
- (2) The examiner should first determine if the costs are “ordinary and necessary” to the direct selling business. Next the examiner should look at the various items to determine if for example the business usage is properly documented and allocated for mixed use costs such as cell phones and vehicles. Other areas that the taxpayer should consider are if the meals and entertainment meet the code and regulations related to deducting such expenses? Are business activities being conducted in the home, do they meet the requirements for deduction of home office expense deduction and are they correctly computed? When the taxpayer claims a deduction for compensation to relatives and especially children, are the individuals providing a service to the business, are all payroll taxes and reporting requirements followed, is the compensation reasonable?

### **E.5. Automobile Expenses**

- (1) A direct seller is may deduct expenses related to the operation of an auto or truck for business use. If the business owns the vehicle the business may deduct the related expenses and depreciation. If the business owns an automobile the examiner should verify that any personal use is properly documented and accounted for the examiner should also be aware of the luxury auto depreciation limitations. (see IRC § 280F).
- (2) If the direct seller is directing expenses related to the use of a personal vehicle for business purposes, the examiner should verify the existence and reasonableness of mileage logs verifying the business use. The seller has the

option of using the actual costs and the standard mileage rate as published yearly by the Service.

## **E.6. Home Office Deductions**

- (1) The direct seller may also be able to claim a deduction for the expense of using a portion of their home for an office of their direct selling business. For more information on home office deductions, see the Office in the Home chapter of the Schedule C, E and F Expenses book on the Expenses and Deductions shelf within the Form 1040 Knowledge Base in the Servicewide Virtual Library.

## **E.7. Partnership v. Sole Proprietorship**

- (1) Many direct sellers are sole proprietors who file a Form 1040 Schedule C. A sole proprietorship is an unincorporated business owned by one individual. It is the simplest type of business organization. The business does not exist apart from the proprietor (owner). The proprietor assumes the risks of the business to the extent of all his/her assets, whether the assets are used in the business. Members of a family can be partners. So, if a husband and wife jointly own and operate a business, a partnership exists.
- (2) A partnership is an association of two or more persons to carry on as co-owners a business for profit. Each person contributes money, property, labor, or skill and expects to share in the profits and losses. For federal income tax purposes, IRC §§ 761(a) and 7701(a)(2) defines the term “partnership” to include a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on and not classified as a trust, estate, or corporation. Whether a partnership exists for tax purposes depends on the parties’ intent, which is determined by looking at all the facts and circumstances of the business relationship.
- (3) Members of a family can be partners. So, a partnership exists if a husband and wife jointly own and operate a business. In the direct selling business, one spouse often signs up as the company’s representative and the other spouse “helps” out with the selling, bookkeeping, other duties, and activities. In most instances, the spouse that is not the registered representative is treated as a non-employee. In other words, they are not paid a salary, nor are they issued a Form 1099-MISC for their services rendered. Even so, a partnership may exist for tax purposes.
- (4) Partnerships generally file a return on Form 1065, U.S. Return of Partnership Income. The return shows the income and deductions of the partnership, the name and address of each partner, and each partner’s distributive share of the partnership’s income, gains, losses, deductions, and credits. The Form 1065 is not required until the first tax year the partnership has income or deductions. In addition, a return is not required for any tax year a partnership neither receives income nor pays or incurs any expenses treated as deductions or credits for federal income tax purposes.



- (5) Each partner's distributive share of the partnership's income, gains, losses, deductions, and credits is reported on the Schedule K-1 for the Form 1065 and must be included on the partner's tax return, even if the items being reported were not distributed.
- (6) Unless the direct seller is a limited partner, the distributive share of income from a partnership is self-employment income. If a husband and wife are partners, they each should report their share of partnership income or loss on a separate Schedule SE (Form 1040), Self-Employment Tax. Reporting the partnership income on separate Schedules SE will give each spouse credit for social security earnings, on which retirement benefits are based.

## **E.8. Employee v. Independent Contractor**

- (1) The services of a direct seller are any services that customarily are directly related to the trade or business of selling (or soliciting the sale of) consumer products in the home or in any other location that does not constitute a permanent retail establishment. Such services include any activity to increase the productivity of other individuals engaged in such sales, such as recruiting, training, motivating and counseling such individuals.
- (2) A direct seller usually signs up with a company to sell its product line. The company may refer to the direct seller by one of the following titles (but not limited to):
  - Consultant
  - Coordinator
  - Dealer
  - Demonstrator
  - Designer
  - Director
  - Distributor or direct distributor
  - Instructor
  - Manager or supervisor
  - Representative or sales representative
  - Independent business owner
- (3) Direct sellers are self-employed. This generally means that they must pay self-employment tax. They must be in business for themselves. Selling consumer products as a company employee does not make them direct sellers. Likewise, working under another direct seller does not make them an employee of that direct seller.

- (4) An individual may be engaged in the trade or business of selling or soliciting the sale of consumer products if they attempt to increase the sales of direct sellers who work under them (their down-line group) and their earnings depend in part on how much that person sells. Recruiting, motivating, and training are examples of attempts to increase direct seller sales. An individual is not a direct seller if they simply host a party at which sales are made.
- (5) IRC § 3508(b) (2) defines the term “direct seller” to mean any person if such person:
- is engaged in the trade or business of selling (or soliciting the sale of) consumer products to any buyer on a buy-sell or deposit-commission basis, or any other similar basis which the Secretary prescribes by regulations, for resale (by the buyer or any other person) in the home or otherwise than in a permanent retail establishment, or
  - is engaged in the trade or business of selling (or soliciting the sale of) consumer products in the home or otherwise than in a permanent retail establishment;
  - substantially all the remuneration (whether or not paid in cash) for the performance of the services described above is directly related to sales or other output (including the performance of services) rather than to the number of hours worked; and
  - such person performs the services pursuant to a written contract between such person and the person for whom the services are performed, and such contract provides that the person will not be treated as an employee with respect to such services for federal tax purposes.
- (6) IRS Publication 15-A, Employer’s Supplemental Tax Guide, states that direct sellers are in the category of statutory non-employees and are treated as self-employed for all federal tax purposes, including income and employment taxes, if:
- substantially all payments for their services as direct sellers are directly related to sales or other output, rather than to the number of hours worked, and
  - their services are performed under a written contract providing that they will not be treated as employees for federal tax purposes.
- (7) Rev. Rul. 85-63, 1985-1 C.B. 292, holds that an individual who performs services as a direct seller, as defined in IRC § 3508, is liable for the tax on self-employment income. Prop. Regs. § 31.3508-1(a) provides generally that an individual who performs services as a direct seller after December 31, 1982, shall not be treated as an employee with respect to such services, and the service recipient shall not be treated as an employer, for federal income and employment tax purposes.
- (8) Rev. Rul. 85-63 discusses the following factual situation:

- (9) B, an individual, performs services selling consumer household products door-to-door for Y, a corporation. These services are performed under a written agreement which provides that, for federal tax purposes, Y will not treat B as an employee. B is paid solely on a commission basis. B thus meets the description of a direct seller contained in § 3508(b) (2) of the Code.
- (10) The direction and control that Y exercises over B in the performance of B's services would establish the relationship of employer and employee under applicable common-law rules. Thus, but for the application of § 3508(a) of the Code, B would be Y's employee within the meaning of § 3121(d) (2). Y does not withhold FICA or federal income tax from the remuneration paid to B.
- (11) The Revenue Ruling holds that B is liable for the self-employment income taxes imposed by IRC § 1401.

## F. Questions to ask on this issue:

- (1) **Schedule C** - Is the business properly being reported on the Schedule C, with net income being subject to self-employment tax?
- (2) **Commissions, etc.** - Is the business expensing commissions, management fees, etc.? This could indicate that family members are working for the business. Is a Form 1099 being issued for those individuals being paid \$600 or more for any calendar year? Is the working family member the subject of an employee/employer relationship, using the three classification issues of behavioral control, financial control and relationship/intent?
- (3) **Spouse** - Is the spouse working for the business and being treated as an independent contractor or employee? Does the spouse receive any compensation at all? Is there proper treatment of spousal activity?

## G. Profit v. Not-For-Profit Issue

- (1) IRC § 162(a) generally allows taxpayers to deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including the business of direct sellers. IRC § 212 further allows taxpayers who are individuals to deduct all the ordinary and necessary expenses paid or incurred during the taxable year for (1) the production or collection of income, or (2) the management, conservation, or maintenance of property held for the production of income. Under IRC § 262, however, no deduction generally is allowed for personal, living, or family expenses.
- (2) IRC § 183(a) generally limits deductions, in the case of an activity engaged in by an individual or an S corporation, if the activity is not engaged in for profit. The term "activity not engaged in for profit" is defined by IRC § 183(c) to mean any activity, other than one with respect to which deductions are allowable for the taxable year under IRC § 162 or under paragraphs (1) or (2) of IRC § 212.
- (3) The regulations under IRC § 183 provide nine factors to be used in determining whether a taxpayer is conducting an activity with the intent to make a profit. No single factor controls, some are more important than others in given

circumstances, and other factors may be considered. The mere fact that the number of factors indicating the lack of a profit objective exceed the number indicating the presence of a profit objective (or vice versa) is not conclusive.

- (4) For the most current detailed information on IRC § 183, see the IRC 183 Activities Not Engaged in for Profit Audit Techniques Guide. Also see the IRC 183 Activity Not Engaged In For Profit chapter of the Losses book on the Assets, Basis, Dispositions and Losses shelf within the Form 1040 Knowledge Base in the Servicewide Virtual Library.

## **XI. Chapter 11: International Considerations**

### **A. Introduction**

- (1) Like many other industries, the retail industry is impacted by globalization. While many retailers choose not to venture into international markets and many others that do venture outside their home countries are unsuccessful, there are still reasons why retailers want to go global. For example, European retailers typically face restrictions on development in their home countries; thus, they seek to grow in other markets. Other retailers expand internationally to take advantage of quickly growing consumer markets or to leverage existing assets<sup>2</sup>.
- (2) In the highly competitive textiles, apparel & luxury goods industry, companies are taking steps to improve demand, and to control the underlying costs for their products and their profitability. Steps include shifting production overseas when possible, selling products through new channels, and leveraging opportunities for international expansion into developed and emerging markets, as well as new advancements in technology<sup>3</sup>. Department store operators have not really focused on international expansion in the past but are now beginning to take an interest in expanding their customer base to countries outside the US through internet sales and third party licensing agreements<sup>4</sup>.
- (3) This International chapter of the Retail ATG will give an overview of common issues in examinations of multinational enterprises, including multinational retailers. It is ordered according to the book in the Servicewide Virtual Library that discusses the issue and divided into three sections, in accordance with the shelf on which the book appears within the Virtual Library's International Knowledge Base—Business Outbound issues (applicable to multinational enterprises (MNEs) with a US parent), Business Inbound issues (applicable to MNEs with a foreign parent), and Cross-Over and Other Technical Topics issues (applicable to all MNEs). There are high-level issue summaries for each topic, and beneath each summary is a listing of applicable Practice Units, which provide more detailed guidance on the issues.

### **B. Business Outbound (Multinational Enterprise with a US Parent)**

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<sup>2</sup> Kalish, Ira (2008). Revisiting retail globalization: A Deloitte Research Global Retail Study.

<sup>3</sup> Amobi, Tuna N. (2016). Industry Surveys: Textiles, Apparel & Luxury Goods, Powered by S&P Capital IQ.

<sup>4</sup> Levy, Efraim (2016). Industry Surveys: Multiline Retail, Powered by S&P Global Market Intelligence.

## **B.1. Transfer Pricing Outbound**

- (1) A US-based multinational enterprise (MNE) might seek to lower its effective tax rate (ETR) by shifting earnings to one or more lower tax jurisdictions and then take the position, for book purposes, that those earnings are permanently reinvested offshore (in a “PRI structure”). The Transfer Pricing Outbound book addresses the ways in which U.S. MNEs attempt to export gains, import losses, or shift earnings to lower tax jurisdictions by aligning functions, risks, and assets to offshore PRI structures.

## **B.2. Practice Units for Transfer Pricing Outbound issues:**

- Accounting for Intangibles and Services Associated with the Sale of Tangible Property Outbound
- Cost Sharing Arrangements vs Licensing Alternative
- CPM Simple Distributor Outbound
- Comparison of the Arm's Length Standard with Other Valuation Approaches – Outbound
- Deemed Annual Royalty Income IRC § 367(d)
- Distinguishing Between Sale License and other Transfers of Intangibles to CFCs by US Transferors
- Dual Consolidated Losses Overview
- Foreign to Foreign Transactions IRC § 367(b) Overview
- Inbound Liquidation of a Foreign Corporation into a US Corporate Shareholder
- Outbound Services by US Companies to CFCs
- License of Intangible Property from U.S. Parent to a Foreign Subsidiary
- Outbound Services by US Companies to CFCs
- Outbound Transfers of Property to Foreign Corporation – IRC § 367
- Overview of IRC § 482
- Review of Transfer Pricing Documentation by Outbound Taxpayers
- Sale of Tangible Goods from a CFC to a USP CUP Method
- Corporate Inversions - Overview of Major Issues
- Outbound Transfer of Domestic Stock
- Outbound Transfer of Foreign Stock Followed by CTB Election
- Residual Profit Split Method Outbound
- Outbound Transfer of Domestic Stock

### **B.3. Foreign Derived Intangible Income (FDII)**

- (1) Foreign-Derived Intangible Income (FDII) deduction under IRC § 250(a) is a permanent deduction provided through a preferential tax rate for eligible income of domestic C corporations generated from property sold or services rendered for foreign use. It is effective for years beginning after December 31, 2017. The calculation of the FDII deduction involves consideration of the "foreign use" and "foreign person" requirements. The FDII book provides practical guidance on calculating and reporting the FDII deduction, documentation requirements, and audit tools.
- (2) There are currently no Practice Units published for FDII since this is a relatively new issue. When new FDII units are published, they will be available internally in the International Knowledge Base in the Servicewide Virtual Library and externally on IRS.gov.

### **B.4. Controlled Foreign Corporation (CFC) Income**

- (1) The Subpart F provisions eliminate deferral of U.S. tax on some categories of foreign income by taxing certain U.S. persons currently on their pro rata share of such income earned by their CFCs. The Global Intangible Low-Taxed Income (GILTI) provisions, enacted as a part of the 2017 Tax Cuts and Jobs Act (TCJA), discourage taxpayers from shifting income (in particular mobile income from intangible property) offshore to low- or no-tax jurisdictions.
- (2) Practice Units for CFC Income Issues:
  - Subpart F Overview
  - Concepts of Foreign Base Company Sales Income
  - Concepts of Foreign Base Company Services Income
  - Concepts of Foreign Personal Holding Company Income
  - Computing Foreign Base Company Income
  - Conducting Functional Analysis for Foreign Base Company Income FBCI

### **B.5. Foreign Tax Credits Business**

- (1) A U.S.-based MNE may seek to optimize its foreign tax credit (FTC) position because some foreign income taxes may be lost and unavailable for FTC post-TCJA. Tax planning within and between the separate categories of income ("baskets") is vital to mitigate any loss of FTC and may also create opportunities to maximize a taxpayer's Effective Tax Rate ("ETR"). The Foreign Tax Credits Business book addresses the ways in which U.S. MNEs manage their FTC and foreign source income ("FSI") positions.
- (2) Practice Units for Foreign Tax Credit issues:
  - Exhaustion of Remedies
  - Exhaustion of Remedies and Transfer Pricing

- Exhaustion of Remedies in Non-Transfer Pricing Situations
- How to Allocate and Apportion Research and Experimental Expenses
- Overview Expense Allocation and Apportionment
- Overview of Interest Expense Allocation and Apportionment in Calculation of the FTC Limitation
- Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit
- Asset Valuation Using the FMV Method for Interest Expense Allocation to Calculate FTC Limitation

## **B.6. Repatriation**

- (1) A US-based MNE may eventually seek to repatriate offshore cash from the low-tax earnings and profit (E&P) pools in its permanently reinvested offshore income (PRI) structures without undercutting its effective tax rate planning by incurring residual U.S. tax. The Repatriation book addresses the various repatriation techniques used by U.S. MNEs that seek to avoid U.S. taxation on repatriated earnings (including under the deemed repatriation rules of IRC § 956). It also addresses the IRC § 965 Transition Tax, which was enacted as a part of the 2017 TCJA.
- (2) Practice Units for Repatriation issues:
  - IRC 965 Transition Tax Overview
  - Calculation of 956 Inclusion
  - Short Term Loan Exclusion from United States Property

## **C. Business Inbound (Multinational Enterprise with a Foreign Parent)**

### **C.1. Jurisdiction to Tax Business**

- (1) If an MNE forms a subsidiary taxed as a U.S. corporation, that U.S. subsidiary is taxable on its world-wide income. However, if the MNE engages in U.S. activities through a branch or partnership, the question is whether a U.S. "trade or business" (or, where a treaty applies, a "permanent establishment") exists. The Jurisdiction to Tax Business book addresses the threshold question of when the U.S. activities of a foreign-based MNE create a U.S. trade or business (or permanent establishment where a treaty applies).
- (2) Practice Units for Jurisdiction to Tax Business issues:
  - Branch Level Interest Tax Concepts
  - Branch Profits Tax Concepts
  - Fundamental Rules for Sourcing for Foreign Corporations
  - Fundamentals of Gross Effectively Connected Income Non-Treaty

- General Deductions of a Foreign Corporation Engaged in a US Trade or Business Non-Treaty
- Gross Effectively Connected Income of a Foreign Corporation Non-Treaty
- Hedge Fund Basics
- Interest Expense of a Foreign Corporation Engaged in a USTB Non-Bank Non-Treaty
- Interest Expense of US Branch of a Foreign Bank Non-Treaty
- Protective Returns Non-Treaty
- Sec 861 Home Office and Stewardship Expenses

## **C.2. Transfer Pricing Inbound:**

- (1) If subject to U.S. tax on its U.S. business activities, a foreign-based MNE may seek to minimize income subject to U.S. taxation (due to the relatively high U.S. corporate tax rates). The Transfer Pricing Inbound book addresses ways in which foreign-based MNEs may attempt to export gains, import losses, or shift earnings outside the U.S. by aligning functions, risks, and assets to related offshore entities.
- (2) Practice Units for Transfer Pricing Inbound issues:
  - Advance Pricing Agreement for Tangible Goods Transactions Inbound
  - Arms Length Standard
  - Best Method Determination for an Inbound Distributor
  - Common Ownership or Control Under IRC 482 - Inbound
  - Comparability Analysis for Tangible Goods Transactions Inbound
  - Comparison of the Arms Length Standard with Other Valuation Approaches – Inbound
  - Competent Authority Revenue Procedure 2015-40 Guidance Foreign-Initiated Adjustments
  - CPM Simple Distributor Inbound
  - Foreign Shareholder Activities and Duplicative Services
  - High Value Services Technical and Marketing Services Inbound
  - Inbound Resale Price Method Routine Distributor
  - License of Foreign Owned Intangible Property by US Entity
  - Management Fees
  - Outbound Liquidation of US Corp to Foreign Parent IRC 376(e)(2) Overview



- Purchase of Tangible Goods from a Foreign Parent CUP Method
- Residual Profit Split Method-Inbound
- Revenue Procedure 99-32 Inbound Guidance
- Review of Transfer Pricing Documentation by Inbound Taxpayers
- Services Cost Method Inbound Services
- Taxpayers Affirmative Use of IRC 482
- Three Requirements of IRC 482

### **C.3. Inbound Financing**

- (1) A foreign-based MNE might seek to further reduce its U.S. tax base through inbound financing structures that generate U.S. tax deductions but have minimal taxation to foreign counter parties. The Inbound Financing book addresses various inbound financing techniques and provides tools and resources for examining these financing arrangements.
- (2) Practice Units for Inbound Financing issues:
  - Ability to Service and Repay the Debt
  - Bona Fide Debt Determination
  - Deductibility of Foreign Related Party Financial Guarantee Fees
  - Hybrid Instrument with a Repurchase Agreement
  - Interest Expense Limitation Computation Under IRC 163j
  - Interest Expense Limitation on Related Foreign Party Loans under IRC Section 267a3

### **C.4. Base Erosion and Anti-Abuse Tax (BEAT)**

- (1) Base Erosion and Anti-Abuse Tax (BEAT) is a new additional corporate tax under IRC § 59A. It applies to applicable corporate taxpayers that have 3-year average annual gross receipts greater than or equal to \$500 million and have a base erosion percentage greater than or equal to 3%. The BEAT is effective for years beginning after December 31, 2017. The final regulations under Treas. Reg. § 1.59A were issued in December 2019 and provide detailed guidance regarding which taxpayers will be subject to BEAT, the determination of what is a base erosion payment and base erosion tax benefit, the steps required for calculating the base erosion minimum tax amount, and certain reporting requirements. The BEAT book provides practical guidance on examining the BEAT issue, describing detailed documentation requirements, and audit tools.
- (2) There are currently no Practice Units published for BEAT since this is a relatively new issue. When new BEAT units are published, they will be available internally in the International Knowledge Base in the Servicewide Virtual Library and externally on IRS.gov.

## **C.5. Withholding Business**

- (1) A foreign-based MNE might eventually seek to repatriate its U.S. profits without incurring U.S. withholding taxes on the distribution. In addition, a foreign-based business may attempt to minimize or avoid U.S. withholding taxes on payments from its passive U.S. investments. The Withholding Business book addresses the U.S. withholding tax rules that apply to payments of U.S. source income to foreign taxpayers including fixed or determinable annual or periodical (FDAP) income, branch level profits and interest, real estate investment trust (REIT) distributions and partnership effectively connected income (ECI).
- (2) Practice Units for Withholding Business issues:
  - Adjustments for Overwithholding on Form 1042
  - FDAP Income
  - FDAP Payments – Statistical Sampling and Projection Procedures
  - FDAP Withholding Under Chapter 3
  - Non Services FDAP Income
  - Payee Documentation for Treaty Benefits
  - Portfolio Debt Exemption Requirements and Exceptions
  - Services Income Concepts
  - Taxation and Withholding on REIT Distributions
  - Treaty Claims on FDAP Payments Received by Fiscally Transparent Entities

## **D. Cross-Over and Other Technical Topics (any Multinational Enterprises)**

### **D.1. Treaties**

- (1) Tax treaties may fundamentally affect the taxing jurisdiction of each treaty partner by modifying the results that might otherwise be obtained under domestic law. Where a transaction or cross-border payment of either an individual or business taxpayer involves a country with which the US has a treaty, the relevant terms of the treaty may affect the tax consequences of the transaction. The potential effect of a treaty should always be considered in the case of both inbound and outbound transactions and payments. The Treaties book provides tools and resources to assist in identifying and analyzing treaty considerations.
- (2) Practice Units for Treaties issues:
  - Competent Authority Process Under a MAP Article
  - Creation of a PE through the Activities of a Dependent Agent in the U.S.

- Creation of a Permanent Establishment through the Activities of Seconded Employees in the United States
- Preparatory and Auxillary Treaty Exception to Permanent Establishment Status
- Qualification for Treaty Benefits under the Publicly Traded Test

## **D.2. Exchange of Information:**

- (1) Exchange of Information (EOI) refers to the sharing of tax-related information between two or more countries for tax administration and enforcement purposes. Generally, exchanges of tax-related information between national tax authorities occur under the provisions of international tax information sharing agreements. In certain situations, information important to auditing a tax return is located outside the U.S. and examiners may be able to use EOI procedures to access that information. The Exchange of Information book provides additional information on the pertinent issues including specific exchanges, spontaneous exchanges, automatic exchanges, and other types of EOI exchanges.
- (2) Practice Units for Exchange of Information issues:
  - Field Procedures for Handling Foreign Initiated Specific Requests under EOI Agreements
  - Field Procedures for Handline US Initiated Specific Requests Under EOI Agreements
  - Introduction to Traditional Automatic Exchange of Information
  - Overview of Exchange of Information Programs
  - Types of EOI Exchanges

## **D.3. Information Gathering**

- (1) Information Gathering addresses the tools and resources needed to secure information thought to be located outside the U.S., other than through the EOI process. It also focuses on the various penalties for failure to file information returns for foreign entities and transactions. The Information Gathering book provides additional information on the pertinent issues including using alternative means to obtain foreign-based evidence, issuing a formal document request, and Form 5471 penalty provisions.
- (2) Practice Units for Information Gathering issues:
  - Calculating the Net Adjustment Penalty for a Substantial Valuation Misstatement
  - Issuing a Formal Document Request when a US Taxpayer is Unresponsive to an IDR

- Monetary Penalties for Failure to Timely File a Complete and Accurate Form 8865 Category 1 and 2 Filers
- Monetary Penalties for Failure to Timely File a Substantially Complete Form 5471 for Category 4 and 5 Filers
- Using Alternative Means to Obtain Foreign Based Evidence
- Using an Authorization of Agent when a US Corporation is 25 Percent Foreign Owned
- Using an IRC 6038A Summons when a U.S. Corporation is 25 Percent Foreign Owned
- The Meaning of Substantially Complete with Reference to International Information Return Penalties

#### **D.4. Foreign Currency**

- (1) Fluctuations in currency exchange rates give rise to U.S. tax consequences in two situations: (1) where a taxpayer has entered into a transaction denominated in a currency other than its "functional currency" and (2) where a taxpayer accounts for a separate "qualified business unit" (QBU) in a currency other than the taxpayer's functional currency. The Foreign Currency book addresses the U.S. tax rules for recognizing currency gain or loss realized on a transaction denominated in a non-functional currency, as well as for accounting for currency fluctuations (on a translation basis) with respect to a taxpayer's non-functional currency QBUs.
- (2) Practice Units for Foreign Currency issues:
  - Change in Functional Currency IRC § 985 and Procedural Matters and Calculations
  - Character of Exchange Gain or Loss
  - Definition of Appropriate Exchange Rate Overview
  - Disposition of a Portion of an Integrated Hedge
  - Exchange Gains or Losses on Payables and Receivables
  - Functional Currency Determination
  - How to Assess Penalties for Failure to File a Form 8886 Disclosing IRC 988 Losses
  - Overview of IRC 988 Nonfunctional Currency Transactions
  - Overview of Qualified Business Units (QBUs)
  - Sourcing of Exchange Gains or Losses in Currency Transactions
  - Functional Currency of a QBU
  - Disposition of Nonfunctional Currency

- Overview of IRC 986(c) Gain or Loss Prior to Tax Cuts and Jobs Act of 2017
- Official vs Free Market Exchange Rate
- Computation and Review of IRC 986(c) Gain or Loss – Pre-TCJA

## **D.5. Organization/Restructuring**

- (1) Understanding how the corporate structure of both the U.S.- and foreign-based businesses can affect their tax results is critically important. Every international examination should begin with a review of the taxpayer's global organizational structure and any changes to the structure during the period under exam. Businesses often undertake reorganizations to enhance their global tax positions. The Organization/Restructuring book provides tools and resources for understanding a taxpayer's organizational structure and for analyzing reorganizations to determine both their immediate tax consequences and their impact on the taxpayer's longer-term tax position.
- (2) Practice Units for Organization/Restructuring issues:
  - Overview of Entity Classification Regulations aka Check-the-Box
  - Corporate Inversions – Overview of Major Issues

## **D.6. Earnings and Profits**

- (1) Earnings and Profits (E&P) is a fundamental concept in the taxation of corporations; however, the term is not defined in the IRC or regulations thereunder. Instead, E&P is an economic concept utilized by the tax law which represents the increase in a corporation's assets net of contributions to capital and liabilities incurred. The E&P book connects you to existing resources that aid in the risk analysis and examination of both domestic and international issues involving E&P. Note that the E&P book was recently moved to the Corporate Issues shelf in the Corporate/Business Issues & Credits Knowledge Base from the International Knowledge Base, even though it also deals with international issues.
- (2) There are currently no Practice Units published for Earnings and Profits since this is a relatively new book. When new E&P units are published, they will be available internally in the International Knowledge Base in the Servicewide Virtual Library and externally on IRS.gov.

## **XII. Chapter 12: Additional Information**

### **A. Useful Retail Web Sites**

- (1) Some useful recommended web sites include the following:
  - Electronic Retailing Association
  - National Retail Federation
  - Food Marketing Institute

- Retail Industry Leaders Association
- National Association of Chain Drug Stores
- National Association of Convenience Stores
- National Grocers Association
- Hoovers
- BizStats.com
- Supermarket News
- Progressive Grocer

### **XIII. Chapter 13: Exhibits**

#### **A. Exhibit 1: E-Business/E-Commerce**

##### **A.1. Explanation for E-Business Online Retail & Services Interview Questions**

- (1) **Question 1:** Do you have an internet presence (web site, web page, e-mail, ad banner) for business purposes?
- (2) **Question 1 explanation:** It is important to determine the extent of the retailer's involvement with the internet. Keep in mind that a web presence does not necessarily mean that the retailer is involved in e-business. A business may have a web site that is purely for advertising purposes with nothing sold online. For example, a national restaurant chain might have a web site that contains their menu and a listing of their locations.
- (3) **Question 2:** Do you conduct business transactions over the internet? (e.g. Do you accept orders and/or payments over the internet?) If so, what types of records do you maintain for these transactions? (All electronic? Paper documents?)
- (4) **Question 2 explanation:** The examiner will determine the nature and volume of business transacted online along with the types of records maintained. Payments made over the internet must be considered as part of the minimum income probes. Identify the accounts from which the payments are drawn. The payments are considered an application of fund that should be accounted for in the financial status analysis.
- (5) **Question 3:** What products, services or memberships may customers purchase on your web site or through email?
- (6) **Question 3 explanation:** The interview process often provides leads that are useful for checking and verifying reported income later when the examiner reviews the actual books and records. For example, the retailer may describe a list of products a, b, c, d & e. Yet when the examiner reviews inventory records, only products a, b, & c are on hand. It is possible the examiner is auditing an earlier tax year and the retailer did not start selling d & e until the current year.

Or maybe the retailer omitted the sales of items d & e from their tax return. Compare the retailer's answer to the information from their website, and to the sources of income identified in the books and records.

- (7) **Question 4:** When was the web site "opened" for business? Did the business exist prior to creation of the web site? Is the business you conduct over the internet separate or distinct from your historic line of business?
- (8) **Question 4 explanation:** How the business is audited depends in significant part on the driving force behind the expansion of the business. Is the internet-based business an extension of an existing business or does it represent a completely new endeavor?
- (9) It is important to establish the date the web site became operational. The date the retailer obtained its domain name may coincide with the date the web site opened for business. Review invoices from paid website consultants, receipts from purchases of software, and bills from the retailer's internet service provider (ISP). Dates on these source documents may indicate when a web site became operational or when there was a significant upgrade in the capabilities of the web site to offer interactive business services.
- (10) **Question 5:** What domain names are registered to the business (either by you or on your behalf)? What domain names do you have control over? Please provide the date of registration and the name of the registrant.
- (11) **Question 5 explanation:** The domain name is the web address used to find a site on the internet. Just as it is important for an examiner to tour a brick and mortar retailer, it is important for the examiner to review a retailer's websites. Each website is just like a separate brick and mortar store with a separate cash register. Identifying the number of websites a taxpayer has is no different than identifying all the possible business sites or cash generators on your tour of a physical business location.
- (12) Domain name information can be obtained from InterNic. InterNic is the directory service under contract with the U.S. Government to register and track domain names. InterNic's registry includes the name, address and phone for the registrant, the billing and technical contact points, the host site name and its internet protocol (IP) address.
- (13) Website owners typically renew existing domain names annually for a fee. New domain names may be acquired from domain name brokers. Third party domain name brokers can register domain names with InterNic for a nominal fee on the speculation that the name may later be desirable and may appreciate in value. The resale value may exceed several hundred or even several thousand dollars. These domain names may be capital expenditures that are amortizable over their useful life. (See CCA 201543014).
- (14) **Question 6:** How is the fee for internet connection services determined?
- (15) **Question 6 explanation:** A standard taxpayer reply is "from the bill." The correct answer, however, is not so obvious. The fee charged by the ISP might

be either connection or volume based. A connection-based fee is based on the simple fact that the retailer is paying for basic point of presence (POP) on the internet.

- (16) A volume-based fee is based upon bandwidth and/or storage volume. Bandwidth refers to the ability of a site to handle access volume. For example, a million simultaneous hits might be more than most servers could sustain without crashing. As access to a site grows, the host must expand its ability to service multiple users by expanding its bandwidth. Therefore, a large bandwidth implies a high-volume website.
- (17) Storage volume is associated with the sophistication of the website. The website is resident on the host company's computer as a sub-directory. The sub-directory consists of separate text, graphic, video, and sound files. The larger and more graphics-heavy the website, the more storage space is required when someone accesses the website.
- (18) In addition to bandwidth and storage, volume-based billing may include charges for other ancillary services. These services may involve special routines such as computer graphics interchange routines, Perl Scripts and server-side applications. The billing for these extras is not necessarily volume based but is generally associated with high-volume sites. In summary, the higher cost of a relatively more sophisticated website implies a higher volume of business.
- (19) **Question 7:** How did you develop your internet website (i.e. outside consultant, internal staff, website design software)?
- (20) **Question 7 explanation:** If the examiner identifies website development costs as an issue for exam, exam should consider requesting details regarding consulting fees, design fees, employee salaries, non-employee compensation, design software, etc. The proper tax treatment of website development costs is the subject of controversy. Should website development costs be expensed or capitalized? Should the costs be aggregated into one intangible asset and amortized? Alternatively, should the retailer apply pre-internet precedents to expense some of the website costs (like software) and capitalize others (such as logo and trademark expenditures)? It is important to quantify the various categories of website design costs. See Questions 8 & 9 for additional discussion.
- (21) **Question 8:** How many employees are engaged in the internet-based business activity? (If applicable & necessary, secure a list of the employees, job titles, compensation, etc., responsible for website design and website hosting.)
- (22) **Question 8 explanation:** Many internet-based businesses, especially startup companies, are "sweat equity" or "bootstrap" operations. The retailer may do much or most of their own website design and hosting activity rather than paying an outside party. The purpose of this question is to quantify how much of those internal costs might be associated with web development. Be alert for equity interests given in lieu of compensation for web design services.



- (23) **Question 9:** What type of credit cards do you accept from consumers making online purchases?
- (24) **Question 9 explanation:** An internet business can accept various types of credit cards and process the payments through multiple financial intermediaries. The need to examine this area in detail is critical because the diversion of credit card receipts is a primary vehicle for underreporting income from internet sales. A flow chart of the transactions through the system, especially the interface between the website and the accounting records, is a useful tool in identifying “leakage” of receipts from the system.
- (25) **Question 10:** What is the name of the financial institution(s) that clears your credit card receipts? Did you complete an application or merchant services sign-up form for the credit card clearing services?
- (26) **Question 10 explanation:** There is a wealth of information on the sign-up form, so the examiner should ask to see copies of all the form(s). In addition to the name of the financial institution, the examiner should make note of the account numbers, dates the accounts were opened and closed, and changes in financial institutions.
- (27) In most retail businesses, the merchant receives approval as a credit card vendor from a commercial bank. Usually a small business, such as your neighborhood hardware store, will use the services of a local bank. The typical flow of transactions is as follows:
- the retailer deposits the credit card slips to its account,
  - the bank posts the deposit to the credit card processing account
  - then the bank posts a transfer deposit to the retailer’s checking account.
- (28) There are no geographic limits on the internet, so the connection with the local financial community may be minimal for an internet-based business. In addition, banking and credit card relationships may be fractionalized on the internet. For example, Company A may be using a credit card processor to verify account number validity, a second financial institution to provide credit card merchant (clearing) services, and a third financial institution to serve as a depository for the proceeds of the transactions. This last financial institution may be a local bank or may be located anywhere in the world.
- (29) Some retailers may transfer funds from internet sales to an undisclosed offshore bank account. For example, the retailer may have a domestic bank serve as the depository for the credit card receipts. The domestic bank’s private banking department then facilitates transfer of funds to an offshore subsidiary. The offshore subsidiary then issues the taxpayer a credit card, which is funded by the offshore account.
- (30) The lesson here is that someone different can handle each separate step of processing a credit card sale, sales slips exist only as an account number, and the final deposit can go anywhere.

- (31) **Question 11:** Does your internet service provider or the entity that is providing you server space process your credit card transactions?
- (32) **Question 11 explanation:** There are several website hosting services that will provide a free website in exchange for the exclusive right to process the credit card transactions originating with that website.
- (33) **Question 12:** Have you used any other financial institutions in conjunction with your website? If yes, secure the same information discussed under question # 10.
- (34) **Question 12 explanation:** See explanation under question #10 above.
- (35) **Question 13:** Does your financial institution(s) provide any of the following services:
- *charge authorization*
  - *transaction capture*
  - *settlement*
  - *charge-back handling*
  - *reconciliation*
  - *reporting, or*
  - *prepaid card issuance and acceptance*
- (36) **Question 13 explanation:** This list refers to various features that a financial institution may provide to a typical retailer. Charge authorization establishes that a hold is placed on a customer account at the time of order to minimize sales in excess of the customer's credit limit. Transaction capture refers to the process of recording the actual sales transaction for the retailer.
- (37) Settlement is the actual transfer of funds to the retailer's account in settlement of the customer charge. Charge-back handling refers to the situation where a customer objects to a specific bill. This amount is then "charged back" or offset against the retailer's other settlements.
- (38) Reconciliation involves the process of clearly establishing the sources and payment of sales to the actual settlement remittances provided to the retailer. Reporting is the provision of statements detailing sales activity.
- (39) Prepaid card issuance and acceptance refers to what is sometimes known as a debit or prepaid card in which the customer prepays an amount. It is good until exhausted and may be replenished by the customer by additional payments. Phone cards, toll cards and some debit cards are examples of prepaid cards.
- (40) **Question 14:** What type of purchase payment enabling software do you use? (Make note of the vendor name and address. If the taxpayer does not know the name of the software, ask if the ISP hosting the website is providing the software.)

- (41) **Question 14 explanation:** This is an area that is changing on an almost daily basis. To process a payment from an internet website a special type of software must be in place. It uses the security aspects of secure socket layer (SSL) type technology to make sure that credit card data cannot be intercepted.
- (42) There are several retail software packages that enable a site to conduct business. Many of the newer ones use an out-of-the-box, "load the software and you're in business" approach. For a minimal fee, the software vendor will also handle the actual sales activity.
- (43) **Question 15:** How are credit sales handled and how are they recorded in gross receipts?
- (44) **Question 15 explanation:** This is also a question the examiner should ask in any brick and mortar business audit. However, with an internet-based sales operation, the process can change several times as the retailer experiments with alternative sources and financial institutions.
- (45) **Question 16:** How are non-credit sales handled and how are they recorded in gross receipts?
- (46) **Question 16 explanation:** The retailer's response to this question will explain whether transactions paid for using check, e-check, money order, cash, etc. are handled differently than credit card sales.
- (47) **Question 17:** What is the process for authorizing and approving credit card purchases?
- (48) **Question 17 explanation:** This question is designed to address the actual steps used in approving and authorizing a customer credit card number for a purchase from a commercial website. When making a purchase at a typical brick and mortar retailer, the consumer inserts or slides their credit card in a reader at the cash register (or presents their credit card and the merchant runs it through a credit card reader). A deposit is then automatically made to the retailer's bank account.
- (49) An internet-based company can perform the credit card approval and authorization process using various online vendors who never even see the customer. A flow chart should be used to document the steps in the purchase process. The monthly processing cycles, deposit periods, and holdbacks may affect the proper reporting of income depending on the retailer's method of accounting.
- (50) **Question 18:** What is the sequence from order entry to shipment?
- (51) **Question 18 explanation:** This question is a follow-up to question number 17 and answers such things as when income should be accrued, when inventory is relieved, and when items are shipped. The examiner can use the retailer's response to establish the cutoff periods that should be used for tax purposes.
- (52) The purpose of flowcharting (a.k.a. system walkthrough) and documenting (verifying audit trail) all the steps in the process is to determine whether the

retailer's accounting method corresponds with the physical flow of goods and services. In addition, the walkthrough may identify weaknesses in internal control that would warrant an adjustment to the scope of the audit plan.

- (53) **Question 19:** How are products shipped and which shippers are used?
- (54) **Question 19 explanation:** Retailers use many different shippers and common carriers. Some of the ones that are frequently used by internet-based companies include the U.S. Postal Service, FedEx and UPS.
- (55) Shipping records contain several useful pieces of information. First, the total cost of "freight out" is indicative of the total volume of sales. Second, the information in shipping records can assist with inventory related questions such as:
- consignments
  - relief or reduction of inventory at year end
  - timing of inventory reductions
  - transfer or title
  - reimbursement for insurance, shipping and handling costs
- (56) Finally, the records from the shipping company can be used as an "independent third party" for internal control and to verify income reported.
- (57) **Question 20:** Who are your major suppliers and vendors?
- (58) **Question 20 explanation:** The examiner should document a list of the retailer's product vendors to use in examining sales and inventory.
- (59) **Question 21:** What is the origin of the shipments?
- (60) **Question 21 explanation:** Unlike traditional brick and mortar retailers, internet-based companies may not ship out of a warehouse that is co-located with the rest of the business. In fact, items sold over the internet are frequently "dropped shipped." This term refers to the process whereby goods are shipped directly from the manufacturer to the ultimate purchaser. There is no intervening warehousing by the seller, except to consolidate items from multiple sources into one shipment to a customer.
- (61) The use of "just in time" or "virtual" inventories may affect the allowable method of accounting, the timing of inventory reductions, recordation of consignments, and the efficacy of inventory write-downs. Additionally, items "dropped shipped" from foreign sources to foreign destinations may indicate the existence of foreign source income.
- (62) **Question 22:** Do you have any paid referral or advertising contracts with other internet websites? (If the answer is yes, obtain copies of the contracts.)
- (63) **Question 22 explanation:** A business may pay other website operators a fee for referring visitors to its site. This referral fee may be based upon activity such

as the number of hits originating from the referring website. Or it may be a certain percentage of the sales resulting from customers referred from the originating websites.

- (64) Ideally, the referral or advertising contract will describe the relationship between the websites, the referral fee computation and payment terms. However, do not be surprised if the “contract” does not contain all the signatures and elements of a valid contract. Many contracts on the internet are relatively informal. The agreement may be something as simple as a copy of a web page offering terms and prices for setting up a banner ad on another page, and the deal may be consummated via e-mail.
- (65) The examiner may use audit techniques to ascertain how many “click throughs” may have originated from a particular source site during a given period. These methods require access to the ISP’s server log, the ISP’s periodic operational data backups, as well as the retailer’s “statistics directory”. The latter may be found among the website files on the host server. These techniques do not yield conclusive findings but would only serve as an indicator. They may yield potential third parties that the examiner could contact for information on the volume of referrals.
- (66) Websites can change frequently and current information available online may have no relevance to the year under audit. ISPs usually do not retain server logs or data backups for long periods, and this information is largely circumstantial. The number of website hits recorded on the retailer’s site, however, is not circumstantial.
- (67) While contracts may not exist for certain types of internet advertising, payments will. Payment may be in the form of check, electronic funds transfer, or online bank check. Thus, in the absence of a contract, the examiner can follow the money to determine the payment details. If there is a payment for advertising, there is a payee. If there is a payee, there is a payor with one or more of the following obligations:
- To identify the payee as a party not subject to backup withholding,
  - To obtain the taxpayer identification number of the payee and
  - To issue Forms 1099
- (68) If the payor is remiss in his reporting responsibilities, the IRS may assess back-up withholding.
- (69) **Question 23:** Do you swap (barter) links, banner space and server space with any other businesses?
- (70) **Question 23 explanation:** This is a follow-up to question number 22. A link may be associated with a word, logo, picture, or other object on the site. The link automatically directs site users to a separate website when the user clicks the link.

- (71) A banner is similar in function to a link. Its purpose is to take site visitors to the advertiser's website. In general, banners are larger than simple text links and are designed to attract attention. They frequently appear at the top or side of the web page and are designed to function as an interactive electronic billboard. The most common form of bartering on the internet involves the swap of banner space when two businesses place banners on each other's websites.
- (72) In general, a retailer's website is not resident on the retailer's computer, but it is located on a host computer owned by an ISP. The exception is a retailer that owns its own host computer. A website's host computer is called the server.
- (73) This question seeks to determine whether something or some service is being swapped for server space. For example, a company may provide server space to the retailer in exchange for banner space on the retailer's website, for the right to process credit card transactions originating from the retailer's website, or for product.
- (74) The retailer may say they received this link, banner or server space for free. This is becoming more commonplace as costs have dropped dramatically. However, the link or banner increases site visitors, hits and page views. The examiner should consider the fair market value of the items bartered when considering the potential tax effect of these transactions. Fair market value is what someone else would pay for that space on the retailer's website in an arm's-length transaction.
- (75) Storage space can be purchased in the open market for less than a penny per megabyte. The file size of a graphical banner ad with animation could take up almost a megabyte of space on a host's server. So, it may seem the fair market value of such a banner would be fairly low. However, cost is not necessarily equivalent to fair market value. What really determines fair market value of a banner ad is the popularity of the website running the ad. If an auto insurance company advertises with a banner on a large auto dealership's website, the banner will be worth a lot more than if it were on a website operated by XYZ's Junk Yard.
- (76) **Question 24:** Do you have any foreign operations?
- (77) **Question 24 explanation:** The concept of foreign operations is not restricted to activities that require a physical presence in a foreign country. The internet and electronic commerce transcend the limits of geography. If the retailer has extensive foreign sales or investments, the examiner should consider requesting the assistance of an International Examiner or Technical Specialist.
- (78) **Question 25:** Do you have direct or indirect control over any foreign corporations, foreign partnerships, foreign trusts or any other foreign business enterprises?
- (79) **Question 25 explanation:** Sometimes to facilitate operations and financial activity, a business in the U.S. may set up foreign corporations, foreign trusts etc. If the examiner establishes that the retailer controls any foreign entities, the

examiner should request the related returns/forms for these entities. For example, if the retailer has a controlled foreign corporation (CFC), it may file Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. Again, the examiner should consider requesting the assistance of an International Examiner or Technical Specialist.

## **B. Exhibit 2: Planning & Examination of Construction “Tenant” Allowances for Leases Greater Than 15 Years (March 24, 2003)**

### **Introduction**

- (1) This memorandum provides guidelines for the efficient use of audit time and resources devoted to the examination of payments, commonly called "tenant allowances," made by developers to retail lessees with respect to long-term leases. This Memorandum only applies to those taxpayers with leases that do not meet the short-term lease definition of Internal Revenue Code Section 110(c)(2) and 168(i)(3), and its related Regulations. Whether payments received with respect to leases with terms exceeding 15 years are treated as income to the retailer (lessee) will turn on whether the lessee or the lessor is treated as the owner of the property constructed with the construction or "tenant allowance."
- (2) This LMSB Directive is not an official pronouncement of the law or the position of the Service and cannot be used, cited or relied upon as such.

### **Background**

- (3) In the typical situation presented herein, the retailer (lessee) owns some leasehold improvements, and the landlord owns others. Any amounts received from the landlord and expended by the retailer on assets that are owned by the landlord cannot be characterized as income to the retailer. The retailer bears the burden of showing the extent to which monies received from the landlord were expended on leasehold improvements owned by the landlord.
- (4) However, amounts received from the landlord as lease inducements and expended by the retailer as it sees fit or on specific leasehold improvements that are owned by the retailer are includible in gross income unless excludible by some section of the Internal Revenue Code. Thus, in cases in which the tenant holds the benefits and burdens or ownership of the leasehold improvements, the tenant has current income.

### **Current Tax Controversy**

- (5) Whether cash transferred to a retailer as a tenant or construction allowance is includible in gross income under Section 61(a). Specifically, (1) whether the cash payments are accessions to wealth and, if so, (2) whether the retailer may exclude the cash payments from gross income under Section 118 or some other provision of the Code.

- (6) The difficulty in development of these issues lies in the determination of ownership. Ownership for federal tax purposes is determined by applying the benefits and burdens of ownership tests to the facts and circumstances surrounding the transaction. The Tax Court has set forth 8 separate tests to determine ownership for tax purposes. See, for example, *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981), and *Coleman v. Commissioner*, T.C. Memo 1987-195, *aff'd*, 16 F. 3d 821 (7th Cir. 1994). Ownership for tax purposes ultimately is determined using these well recognized tests. However, there is no assurance that symmetry exists between the landlord and the retailer. Unless the planning technique recommended herein is employed, the potential for whipsaws and inconsistent treatment can be eliminated only by examining both the lessee and lessor.

### **Discussion**

- (7) Tenant construction allowances in general are cash payments made either to encourage a retailer to enter a mall in the first instance, or as an incentive for a retailer to continue to operate its store in the developer's mall. In each case the payments are made as part of a contractual agreement.
- (8) Typically, under the terms of the leases, each developer/landlord is responsible for the completion of the gross structure of the shopping center. The retailer is responsible for the build out or finishing work of the interior space it will occupy, as well as other tenant work, such as opening for business, operating the business and advertising. The leases typically require the interior space to conform to certain conditions. Sometimes the landlord must approve the construction plan and completed work.
- (9) A substantial portion of the build out and other tenant work is of the nature that its economic life will not extend beyond the lease term. As an inducement to enter the lease, developers agree to make lump sum payments, usually payable when the build out is completed or portions thereof are completed.
- (10) In many of these situations, the developer and the retailer will specify in the lease itself, or in an ancillary agreement, who is to be considered the owner of the improvements. Such a provision may be couched in terms of who bears the benefits and burdens of ownership.

### **Planning and Examination Guidance**

- (11) Examination should focus on the contract language to the extent possible. When agreement of the parties is clear from the contract language, and both parties are reporting the payment on a basis consistent with the agreement, the treatment of such payments should be treated as a very low risk item in planning and executing the examination plan. Verifying treatment by the developer need not require a full-scale examination of the return. Rather, it can be handled as a check on a reference return. Examiners are encouraged to exercise discretion and judgment as to the extent of such verification.



