

# Retail Industry Audit Technique Guide

**NOTE:** This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date. All references to code sections are to the Internal Revenue Code (IRC) unless otherwise specified.

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# Chapter 1: Description of the Retail Industry

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## *Purpose for the Audit Technique Guide*

The purpose of this Audit Technique Guide is to provide guidance on conducting income tax examinations in the retail industry. It incorporates procedures and techniques that have been shown to be practical or unique to the retail industry that will be combined with the examiner's good judgment, skill and experience to complete the examination within the shortest possible time with the least burden possible to the taxpayer. Use of these techniques does not imply that the object of the examination is to find a deficiency, but rather to determine whether the reported income and expenses have been accurately reported.

Because the facts and circumstances of each taxpayer are unique, the procedures applied will be slightly different in every examination, and the strategy will remain dynamic. The examiner will combine the techniques that apply to each specific case and apply his or her basic knowledge to the practical situation at hand.

## *Description of the Retailer*

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. To do this the retailer may offer only one type of product, where there is little competition, and use a substantial markup (such as an auto dealership), or the retailer may offer many different products or models, so customers will be certain to find an item to buy in this store and not in a competitor's store (such as a convenience store). Some retailers earn a small profit on many items and rely on the volume of sales (such as grocery stores), or turnover, to account for their profits. For these reasons, 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.

## *What Retailers Do*

Retailers purchase a product, mark up its cost, and advertise it for sale. The mark-up process is the key to the retailer's business, because, if the product is marked up too high, consumers will not buy it; if it is too low, the retailer will have lost 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.

These items and products held in the retailer's possession are called inventory. Inventory is money out of the retailer's pocket, so the retailer tries to keep available 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.

## *Demographics of the Retail Industry*

Retailing is one of the largest industries in the United States and accounts for approximately 10 percent of our gross national product. Retail business covers many different areas, including auto dealerships, bars, convenience stores, restaurants, gift shops, clothing stores, merchandise stores, etc.

There has been enormous growth and innovation in American retailing in this century. Neighborhood markets and drugstores of the early 1900's have 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 and the interstate road system improved, suburban shopping centers and malls were created. Chains, franchises and catalogs have built them into national brands today. Retail warehouse concepts continue to increase. Technology has enabled product scanning, sophisticated marketing techniques and Internet shopping.

During the past 2 decades the retail industry has been a leader in the number of mergers and acquisitions. During the 1980's the Wall Street Journal stated that the retail industry was "percolating with mergers and acquisitions." In recent years the retail grocery industry has been involved in numerous acquisitions.

Technology has 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.

### ***Retail Entities***

Small retailers are sometimes called 'mom and pop' stores because they are family owned and operated. An example of this might be a generic convenience store or a boutique in a strip mall. This type of business may be a sole proprietorship. Even if both spouses work in the store, only one may be the proprietor. Only the proprietor spouse may 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. This might be done to give each member a share in profits or it might be formed because the business is growing.

Large retailers may 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.

### ***Useful Retail Web Sites***

Some useful web sites we recommend looking at include:

- [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](#)

### ***Unique General Industry Terminology***

There is some terminology and practices unique to the industry. It is recommended that examiners familiarize themselves with the terms unique to this industry prior to the initial interview in order to facilitate the examination. Each Retail sub-industry will also have it's own unique terminology. See the particular industry section.

Industry Term	Definition or Explanation
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 a percentage of advertising from each tenant. This is used for advertising that will benefit all of the tenants.
Cost Complement	The average relationship existing between the cost of merchandise and the retail value of the items handled during an accounting period. The dollar value of the inventory at cost is divided by the dollar value of the inventory at retail.
Layaway	A method of deferring payments whereby goods are retained by the store until the customer has completed payments for them.
Markdown	A reduction of an originally established selling or previous retail price.
Markup	<p>The difference between cost price of goods and their retail price. The initial margin between the selling price and cost. It also is referred to as mark-on or gross margin.</p> <p>Additional markup: An increase above the original selling price.</p>
Markup Cancellations	<p>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.</p> <p>A reduction in the selling price after there has been an additional markup. The reduction does not reduce the selling price below the original selling price.</p>
Markdown Cancellations	<p>The increase in the retail price of an item that has been reduced.</p> <p>An increase in the selling price, following a markdown, which does not raise the new selling price above the original selling price.</p>
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 retailer's offensive strategy calculated to increase sales. Frequently the promotional markdowns are temporary.
Push Money	Bonus money paid by a vendor or a retailer to sales people for selling specially designated merchandise.



<b>Industry Term</b>	<b>Definition or Explanation</b>
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.
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.
Stock Book	A book, maintained by the buyer, in which are entered additions to stock (inventory) in the form of 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; should not be entered in the books of account, nor should it be considered to 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.
Retail Price	The price at which goods originally are offered for sale.

## **Chapter 2: General Issues in Retail**

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### ***Initial Interview***

The initial interview is an important element of any examination, setting 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. 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.

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:

- *Business Operations*  
Most "mom and pop" stores are cash intensive. Understanding how the taxpayer handles and accounts for the money is very important.

Also secure a statement of how the inventories are valued and the method used. This is needed for calculations of markup and/or gross profit. Find out who actually takes the physical inventories and when they are performed. Ask for the work paper that calculates the inventory value.

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 and it will not be prevented or detected on a timely basis by the business's internal control structure, policies, or procedures.

- *Cash-on-Hand*  
It is imperative that cash-on-hand is covered during the interview. The examiner should probe for all funds the taxpayer had access to 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.
- *Personal Expenditures*  
Many retail business owners use some of their inventory for personal purposes. This is especially noted in a restaurant or grocery business. The key here is to verify that the personal-use amount is properly accounted for and deducted from cost of goods sold or purchases.

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.

## ***Information Document Request***

Shown 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 journal
- Adjustment entries to such items as Sales, excise Taxes paid
- 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
- Work papers supporting the inventory computations
- List of vendors who offer vendor allowances such as rebates
- Documentation of any non taxable income

## ***Books and Records***

Due to the diversity of the industry and the types of business organizations, a variety of books and records may be found 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.

*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 period of time, 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 sale journal. These tapes must be retained by the owner and made available for the examination. Without the Z tapes the examiner cannot know if all transactions are actually being 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.

*Point Of Sale (POS)* - This is a computerized accounting system that records sales along with related items, such as employee’s time and tips received, or reductions to inventory and calculations of profit on each sale. These machines 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 examination specialist who will run an audit test of the computer program.

*Inventory Reports* - if maintained. The retailer will usually take a physical inventory annually to determine if there is old merchandise that should be discounted for a quick sale.

*Cash Pay Outs* - As discussed above, the accounting for cash is a primary focus for the examiner. Many 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.

## ***Income Issues***

The examination of Income is a mandatory audit issue and minimum income probes will be conducted during every examination. Please 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 the Minimum Income Probes. If the minimum income probes and examination of gross receipts show all taxable income from known sources is reported, the examination may be limited at that point.

If the results indicate the potential of unreported income due to inaccurate reporting of taxable income from known sources, or if the books cannot be reconciled to the return, or if a material imbalance in the Financial Status Analysis cannot be reconciled, then a more in-depth examination of income is warranted. The examiner will need to decide which techniques are best suited for each individual taxpayer. The following indirect methods have been used successfully in analyzing the sources of income:

### **Cash Records**

Retailers use different types of 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 may record sales and decrease inventory at the same time.

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, the examiner must know who is authorized to do this and what is the procedure? It is also important to find out who takes the cash to the bank and what accounts it may be deposited into.

A thorough understanding of how cash is handled is particularly important in the retail industry. Even with weak internal controls, a taxpayer may be properly reporting income, but the only way for the examiner to know this is to gather detailed information about how the business is conducted, documenting cash inflows and outflows and thoroughly interviewing the owner regarding cash receipts and expenditures.

The records created (hard copy or magnetic media) by the accounting system will also provide a valuable source of information in the examination of the retail businesses. A complete explanation of the accounting system, both in theory and business, should be obtained from the taxpayer prior to beginning the examination of the books and records.

If the taxpayer has a computerized cash register system and cannot provide the requested financial records, the examiner can contact the cash register manufacturer for instructions on how to obtain the reports needed. Most programs made within the last decade run the essential reports necessary to properly determine the correct tax liability and to comply with tip reporting.

During the initial interview, the examiner should ask the taxpayer what percentage of sales is attributed to cash compared to credit or check payments. When the examiner analyzes the bank deposits, this percentage can be verified and any discrepancies can be questioned. During the tour of the business the examiner should be alert to the type of payments that are made and how they are handled.

In spite of the modern record keeping systems available, many choose to report gross receipts according to 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.

Interviews with return preparers who have been found to rely on the bank deposits to reconcile gross receipts (which in most cases understate income) indicated that they were unaware of the computerized record keeping systems. These preparers provide only year-end compilation rather than complete income analysis of services rendered by the retailer business. They have indicated that when they question their clients as to their deposit characteristics and are told that all gross receipts are deposited into the business bank account; the preparer confidently uses the bank statements to report income. Rarely are any adjustments made to the gross deposits shown on the bank statements.

For these reasons the examiner must check for unreported receipts. A retail business is likely to receive many personal checks as payment for services. If the owner is known at the business, whether it is a corporation or sole proprietorship, many of the checks will be made to the retailer personally. It would not be difficult to cash these checks or divert them into personal bank accounts.

Based on this discussion, the business income can easily be diverted from being deposited into the business bank account(s) and reported on the tax return. Therefore, it is imperative that each examination includes alternative methods to verify gross receipts.

### **Indirect Methods**

When the taxpayers' records are not available or are inadequate the examiner should consider the use of the following indirect methods:

- Bank deposit analysis
- Fully developed cash T method
- Source and application of funds
- Net worth method
- Percentage of markup method
- Unit and volume method

The following is a synopsis of the indirect methods and the supporting court cases. The examiner needs to review the appropriate IRM sections for the proper application of these methods. If any of these methods rely on estimates, they should be corroborated by other methods to establish a stronger position. When tracing cash through a bank deposit analysis or using the source and application of funds method, several unique facets of the operations should be recognized.

- Cash payouts are not deposited, but the money used to make the cash purchases originated from sales. This is cash that would not be deposited into a bank account and must be added back to the bank deposit analysis.
- In a restaurant business cash payment of employee credit card tips is money that is not deposited, but originated from sales. Again, this cash must be added back to the bank deposit analysis.
- Sales tax collected from customers for cash sales is money deposited that is not a source of income. In many states the sales tax for restaurants and bars is higher than the sales tax for other retail businesses.
- Cash collected from vending machines is cash that needs to be deposited and included in gross receipts. If significant coin and currency deposits are not found on the deposit slips the examiner may need to determine the amount of income from this source and add it to the bank deposit analysis.
- Credit card payments from credit card companies for sales will include deposits of employee tips plus the sales taxes plus the sale. Only the portion representing 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.

The bank deposit analysis method assumes that the business owner deposits all income in a bank account. In a cash-intensive business such as a bar or restaurant, this may not be the case. For that reason, the bank deposits analysis should generally be supplemented with another indirect method when auditing a bar or restaurant.

To further support an indirect method another examination technique may be used such as having the examiner inspect the supply invoices to find the name of the company that prints the guest checks. This printing company can provide the number of guest checks purchased by the restaurant in a year. A projected income can then be determined from the average amount of the guest check times the number of checks. If these methods are used in combination, they strengthen the case.

In examining a bar, it is possible that the bar owner may remove cash from his or her drawer, purchase liquor off the shelf of a store, sell the drinks in his or her establishment and pocket the profits. (In most states this practice is illegal and bar owners cannot purchase liquor off the shelf or in discount stores.) In such case, there may be no indication in the books that anything is wrong as neither the invoice nor the income touches the books. An indirect method may uncover this.

#### ***Specific Items Method of Determining Income: IRM 4.10.4.5.1***

Before we begin analysis of the retail indirect methods we should discuss the specific items methods. This method is preferable to an indirect method as it is based upon direct evidence of income. For example, a restaurant owner 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 records cannot be obtained from the taxpayer, you may have to contact third parties. If you do, be certain you correctly follow third party contact procedures.

The specific items method of establishing income, supplemented by the bank deposit method, is illustrated in *Ketler v. Commissioner*, T.C. Memo. 1999-68. During 1990 and 1991, Warren Ketler operated two sole proprietorships, including a catering operation doing business as California Barbecue. Mr. Ketler failed to file Federal income tax returns for 1990 and 1991. The Service determined Mr. Ketler's unreported income for these years by reference to Forms 1099 provided by payers. Prior to trial, the Service obtained 1990 and 1991 bank

records for all of Mr. Ketler's accounts and identified various nontaxable transfers and deductible business expenses. Based on this analysis, the Service asked that the Tax Court find increased income tax deficiencies. After trial, the Tax Court found that Mr. Ketler received the income reflected on the Forms 1099. It also found that the Service had properly performed the bank deposits analysis, and, therefore, Mr. Ketler was also liable for increased income tax deficiencies.

*Kikalos v. Commissioner*, T.C. Memo 2004-82, involved liquor store owners, Nick and Helen Kikalos. At the end of each day Mr. Kikalos would receive a bag from his store containing receipts which, among other things, included the cash register tapes (known as "Z tapes") from the store. The Z tapes from these store registers would have allowed for an accurate calculation of the Kikalos' gross income. However, after entering the information in his log books, Mr. Kikalos threw away all of the Z tapes.

When IRS used a mark-up percentage to figure accurate gross receipts, the Kikaloses wanted to use a different indirect method and filed their petition in court.

The court said that arithmetic precision was originally and exclusively in the hands of the Kikaloses, who had simply to keep their papers and data. Having defaulted in this duty, they cannot, in essence, "frustrate the Commissioner's reasonable attempts by compelling investigation and re-computation under every means of income determination." The Court said that other indirect methods of estimating the Kikalos' income are not relevant.

Quoting the Fifth Circuit, the court stated, "While the absence of adequate records "does not give the Commissioner carte blanche for imposing Draconian absolutes," such absence does weaken any critique of the Commissioner's methodology. *Webb v. Commissioner*, 394 F.2d 366, 373 (5th Cir. 1968)."

The court said, "Indirect methods are by their very nature estimates and courts reject the notion that the IRS should have checked their calculations by other methods."

#### ***Bank Deposit Analysis: IRM 4.10.4.3.3.6.***

A bank deposit analysis (BDA) is used to identify deposits that may be taxable, to determine if business expenses were paid from other sources and to determine if business and personal accounts were co-mingled. The deposited items will show whether cash is deposited.

The examiner will analyze the deposits and reconcile non taxable deposit sources, comparing the total deposit with the reported gross income.

If the retail business is cash intensive, where a significant amount of receipts are not deposited and there are many expenses paid with un-deposited cash, a bank deposit analysis would not be a good indirect method for proving income. However the total known deposits should be added to cash expenditures to show the total amount of funds used.

This method is best for retailers whose books are unreliable, but who makes periodic bank deposits and pays expenses by check.

The bank deposits method of establishing income is illustrated in *Ng v. Commissioner*, T.C. Memo. 1997-248. From 1986 through 1990, Big Hong Ng owned interests in several business entities, including various restaurants. Ms. Ng controlled several bank accounts in the United States and Hong Kong. She commingled her personal funds with those of the business entities in which she had an interest. The Service conducted a bank deposit analysis and determined that Ms. Ng failed to report significant amounts of taxable income during the years in issue.

In analyzing the bank deposits, the Service separated cash, checks, cashiers checks and wire transfers. It examined the source of each deposit and separated items subject to self-employment tax from those not subject to such tax. Further, to the extent possible, the Service eliminated those items that had been reported on Ms. Ng's income

tax returns or that came from nontaxable sources (for example, transfers and refinancing proceeds). The Service also analyzed Ms. Ng's cash expenditures. The expenditures that could not be traced to a nontaxable source or reported income were considered unreported income.

***Source and Application of Cash T: IRM 4.10.4.6.4.***

This method analyzes cash flows in comparison to all known expenditures, and shows that if there are excess expense items (applications) over income items (sources) an understatement of taxable income exists.

These methods may be useful for a retail business that has unreported sources of income and when business and personal expenses can be verified.

***Markup Method: IRM 4.10.4.6.5.***

This method reconstructs income based on the use of percentages or ratios for the type of retail business. For example, the examiner would determine the industry markup for a particular type of retailer and apply that markup percentage to the verified cost of goods sold of the taxpayer under examination.

Alternately, the examiner can use the taxpayer's own markup percentages, if possible. A 'shelf test' can be performed where the current sales prices can be compared to the cost of those items to determine the markup percentage. This will be effective if there are only a few types of purchases or only a few suppliers of goods, such as for a gasoline retailer.

This method works well for a business that is cash intensive 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.

***Percentage Markup Method of Determining Income: IRM 4.10.4.6.6***

IRM 4.10.4.6.6.2 states that the percentage markup method is recommended in the following situations:

1. When inventories are a factor and the taxpayer has nonexistent or inadequate records
2. Where a taxpayer's cost of goods sold or merchandise purchased is from one or two sources and these sources can be ascertained with reasonable certainty and there is a reasonable degree of consistency as to sales prices.

Consider the following when applying the percentage of markup method:

- Judgment should be exercised by examiners to make sure the comparisons are made to situations that are similar to those under examination
- The availability of valid sources of information containing the necessary percentages and ratios
- Complexity of the taxpayer's product mix and the availability of valid percentages and ratios for each product
- Length of the period covered during the examination and the need to adjust the percentages and ratios to reflect those existing during the examination

***Computations in the Percentage of Markup Method***

*Possible daily volume X Average check per seat = Daily sales*

The possible daily volume would be the number of seats in the establishment X how many times in a day they are occupied. The possible daily volume can be broken down into time periods in a day (breakfast, lunch, or dinner) to

get a more accurate tally. The average check per seat can be obtained from the taxpayer during the initial interview or from examining the sales tickets.

The daily sales can be extended to weekly and yearly sales based on the days open per week and the weeks open per year.

*Daily sales X Days open in a week = Weekly sales*

*Weekly sales X Weeks open in a year = Yearly sales*

These estimates should take into account the number of vacant seats and people who walk out before paying their bill. The examiner should also look at the taxpayer's advertising account to test the accuracy of reported income. Are specials advertised? How often? Specials may refer to certain menu items or discounted prices or both. Are the times during which specials are offered (for example, happy hour or weekly breakfast hours) reflected in the daily receipts ledger? During the initial interview ask enough pertinent questions to determine if these or any other situations should be considered.

In addition to the above calculations, normal audit procedures should be followed, including tracing gross receipts to bank deposits, analyzing bank deposits of all business and personal accounts of the owner/manager, etc. The examiner will review the interview responses regarding internal controls. Does the same person who counts the daily receipts also make the bank deposit? Are the meal orders taken on numbered tickets or would it be easy to simply not ring up a sale on the cash register for some orders? The examiner must look closely at the supervision habits in the restaurant to evaluate how sales might be understated or how easily theft may occur and by whom.

#### ***Net Worth Method: IRM 4.10.4.6.7***

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.

The net worth method can also be used to corroborate other methods of proof or to test the accuracy of reported taxable income.

The net worth method of establishing income is illustrated in *Michas v. Commissioner*, T.C. Memo. 1992-161. During 1984, the taxpayers owned several sole-proprietorships, including a liquor store. The Service determined that the books and records of these sole-proprietorships were inadequate and analyzed the taxpayer's net worth to determine whether all taxable income had been reported. The Service performed this analysis by determining the cost of the taxpayers business and personal assets at the beginning and end of 1984. The Service then reduced these amounts by the taxpayer's liabilities at the beginning and end of the year. Then, the difference was adjusted by adding nondeductible expenditures (for example, living expenses) and by subtracting nontaxable sources of income (for example, gifts and loans).

The Court largely agreed with the Service, but found that certain adjustments to net worth were not proper. Accordingly, the Court reduced the amount of unreported income determined by the Service.

#### ***Analysis of Gross Receipts***

Before an auditor reviews records for specific sources of receipts, he should do the following:

*Analyze the duplicate deposit slips.* If the business is cash intensive there should be frequent and significant cash deposits. The examiner will calculate the percentage of cash to checks or credit card payments.



*Analyze the cash register tapes.* Cash registers print a daily total called 'Z' tapes. A months worth of Z-tapes will usually be entered into a spreadsheet or handwritten on a monthly sales sheet. Total the monthly sheets to compare 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 that the income was reported before it was paid out for business expenses.

*Sales taxes 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, the examiner should 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.

The examiner should be alert for double deductions in sales taxes paid for purchased items, such as taxes that are included in the cost of goods sold as well as a separate expense item. Sources of Receipts

## **Sources of Receipts**

### ***Vendor Rebates and Allowances***

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. This way payment is made only for the net purchase amount and no income should be recognized.

Some vendors, such as cigarette sellers, allow the retailer to purchase the product at discount or warehouse stores. The vendor then issues a rebate check to allow the purchase for 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.

Income from rebates or credits is includible when received by a cash basis taxpayer, and when the right to receive it becomes fixed and certain by an accrual basis taxpayer.

When a retailer receives allowances or rebates from vendors after the initial purchase of merchandise and fails to properly account for them, the effect will be understating gross profit or improperly reflecting a gross loss on the sale of merchandise.

The examiner should have the taxpayer explain the various types of allowances and rebates that they negotiate and how they account for these allowances for book as well as for tax purposes. The examiner must determine what accounts are used and review the accounting entries, determining how and who maintains the accounts throughout the year. 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. The examiner must consider interviewing buyers or other appropriate personnel who have first hand knowledge of vendor allowances and rebates (in compliance with third party contact provisions), 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, similar monies have been properly accrued or improperly deferred. All vendor accounts will be reviewed to determine if the entries relate in size and timeliness to the information secured.

### ***Credit and Charge Backs***

Sometimes the vendor determines the amount of the allowance or rebate and issues a purchase credit or charge-back 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.

### ***Target Profit Percentage***

Negotiation of the terms of the purchase of merchandise is a major aspect of the retail buyer. The buyer is responsible for assuring that the merchandise to be acquired can be sold at a retail price, which 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 details of the negotiated agreement will either be entered into the product data records or maintained by the retailer. It is obviously in the best interest of the retailer to monitor its progress in earning incentive allowances and rebates to ensure that all potential recoveries are earned.

Generally a contractual relationship will be established between the retailer and the vendor. This relationship can be evidenced by a formal contract or terms described in a letter, memo, or other less formal correspondence.

Generally, these allowances will be reported as an adjustment to purchases or as income. The key here is the association to the product purchased. In the case of a volume discount the rebate is directly associated to purchase, so inventory is discounted. In the case of advertising rebate, the amount is associated to sale of the product; therefore the rebate is other income.

Some of the more common vendor allowances and rebates are as follows:

1. *Volume Discount*  
With this type of discount, the retailer earns money when the quantity in terms 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.
2. *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 types.
3. *Cooperative Advertising*  
In cooperative advertising, a portion of the taxpayer's advertising costs is borne by certain vendors in accordance with cooperative advertising offers of the vendors. For example, a chain restaurant franchisor charges each individual franchise restaurant 3% of their gross receipts. This money is used for national advertising of the restaurant chain.

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. Other allowances may be negotiated between the vendors and the taxpayer's buyers or advertising department personnel. Such agreements generally stipulate the advertising media to be used, conditions relative to the advertising as to the specific product, vendor's name and logo usage, when the advertising is to be performed, size or length of ad, and the amount to be paid or credited to the retailer by the vendor. While it

is common for vendors to make the rebate or credit after the retailer submits proof of meeting the required advertising criteria, some vendors make the rebates or credits in advance of the retailer placing the advertising.

Both the program and negotiated cooperative advertising agreements generally address the retailer's qualification criteria and documentation requirements to be submitted with the retailer's claims for payment or credit. Qualification requirements will specify the term of the offer, eligibility of the retailer, qualifying merchandise, earned accrual, reimbursement percentage, and art and copy requirements. The documentation of the claim will generally consist of proof of advertising, including tear sheets, and the advertiser's invoice to the taxpayer.

The retailer's right to the cooperative advertising allowance will generally arise when the advertising is performed and not at the time documentation is provided to the vendor, or when payment is received by the retailer.

Generally, an accrual method taxpayer that has a right to reimbursement for a portion of its advertising costs by the vendor of the advertised goods, in accordance with a cooperative advertising agreement, accrues the reimbursement under the all events test when the taxpayer places the advertising.

4. *Defective Merchandise*  
This allowance, usually based on a percentage of purchases, covers the cost of defective merchandise or the handling costs related to it.
5. *Markdown Participation*  
Vendors agree to reimburse all or a portion of product markdowns taken on a specific product, in order to instill confidence in the buyer that the product will perform as predicted.
6. *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 of time. In either situation the value [or money] is other income. If the shelving remains the property of the vendor there is no allowance involved.
7. *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.
8. *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.
9. *Free Merchandise*  
The vendor may have a promotion for a specific time period 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.
10. *Handling Allowance*  
The retailer may receive funds from vendors to offset certain costs of handling merchandise, such as the cost of removing ornaments from boxes and placing each item on a shelf.
11. *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 even Halloween.

### ***Deferred Income - Gift Certificates and Gift Cards***

Retailers may issue gift certificates or gift cards. The area of gift certificates and gift cards is one where an examiner may find the retailer deferring income beyond the point where it should be reported. Unless the taxpayer elects the deferral rules of Treas. Reg. section 1.451-5 or Rev. Proc. 2004-34, this income must be reported when received.

Election to Defer Income- If an election is made to defer the income under the Treasury regulation, the general rule is that the income from substantial advanced payments must be reported at the earliest of:

1. the time the income is earned under the all events test;
2. the time the income is recognized under the taxpayer's accounting system, including consolidated financial statements to the shareholders or reports for credit purposes; or the last day of the second taxable year following the year of receipt of a substantial advance payment-\*

\*- [Per Treas. Reg. section 1.451-5(c)(3) any payment received pursuant to a certificate is a substantial advance payment]

Deferred Income and Approval for Change of Accounting Method - Treas. Reg. section 1.451-5(e) states that the deferral of income under this section is considered a method of accounting and approval of the Commissioner is required to switch to it.

Deferral beyond Second Year- The most likely situation that will be encountered is where the retailer is deferring the recognition beyond the second year following the receipt of the cash. This might occur due to poor recordkeeping where no tracking of the outstanding gift certificates is made. However it should be noted that Treas. Reg. section 1.451-5(d) requires the taxpayer to file an information schedule with its return that shows (a) the total amount of advanced payments received in the taxable year; (b) the total amount of advanced payments received in prior years that were included in gross receipts of the current year; and (c) the total amount of advanced payments received in prior years that have yet to be included in income.

The deferral period under Rev. Proc. 2004-34 is a one-year deferral. In order to defer gift certificate or gift card income under either method of accounting, the taxpayer must maintain records to provide the information contained in Treas. Reg. 1.451.5(d).

#### ***Gift Certificate - Deferred Income - Balance Sheet Liabilities***

Because the income from certificates must be reported no later than it is for book purposes; it is not likely that the examiner will see this on the Schedule M. The examiner is more likely to find this issue on the balance sheet as a liability identified as certificates, customer credits or customer deposits. In addition to requesting an explanation or written documentation of their certificate issuance and record keeping procedures, the examiner should request samples of the certificates. Most will bear a serial number that will aid in determining how long the certificates have been outstanding. The taxpayer should also have some internal controls to prevent employees from abusing the certificates and to prevent counterfeiting. The examiner should get descriptions of these procedures and/or manuals as well as any internal audit or security reports dealing with certificates.

Deferral for Up to Two Years- Although Treas. Reg. section 1.451-5 allows for the deferral of recognition for up to two years, the examiner must keep in mind that the all events test under Treas. Reg. section 1.451-1 needs to be applied first. Certificate income is recognized "when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." The regulations do not permit deferral if the income has already been earned. The examiner should therefore examine the retailer's redemption policy. If no cash refunds are permitted or if the certificates expire before the end of the second year, the income may have to be recognized sooner.

Deferred Income - Treas. Reg. section 1.451-5(c) (1) (iii)- Because the merchandise for which certificates can be redeemed generally is not identifiable until the gift certificate has actually been redeemed, no deduction is allowed for the cost of the merchandise at the point the income is recognized under Treas. Reg. section 1.451-5(c)(1)(iii). A deduction is allowed only when the merchandise to be redeemed becomes identifiable, that is, when the certificate is actually redeemed. If the certificates are redeemable for either goods or services (for example, at a department store with a Retailer) the regulations should still be applicable. Gift certificates strictly redeemable for services are governed by Rev. Proc. 2004-34, 2004-22 I.R.B. 991, which has rules that are very similar.

## Other Retail Income Sources

### *Income from Service-Related Activities*

Many retailer establishments will have departments which are designed to support sales and are not a major source of income or expense to the retailer, but which are incidental to the primary business of the store. For example, a retail craft store may have a separate service available for matting and framing. Or, a florist will have some method of arranging bouquets for customers or will sell small gifts. Often these services will be performed in-house.

Methods of detecting other services offered include a tour of the facility, or telephoning the sales location and asking what services are available. Accounts of retailers should be analyzed to determine whether income from service departments exists and, if so, how income and expense is booked. Often, income and expense may be netted into the same account, where a growing credit balance in a balance sheet account may signal an improper deferral of income.

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 section 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 *Marcor, Inc. v. Commissioner*, 89 TC 181 (1987), nonacq., 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.

### *Promotional Allowances*

Promotional allowances are sometimes received before the taxpayer has met all the criteria for earning them. The examiner should apply the all-events test before permitting a deferral of income. Only the unearned portion qualifies for deferral. The examiner should be aware that examination of 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 are likely to result in adjustments to improperly deferred income.

### *Prizes and Trips*

Retailer owners may receive prizes and/or trips from vendors or manufacturers. Since these types of items fall outside the normal data stream, they are easily omitted from income. Similar situations apply to free merchandise received from vendors as part of promotions. If such transactions are booked at all, they may be run through cost of sales. Interviews with the retailer, manager, officer or shareholders regarding trips taken, prizes won, meetings attended, etc., can be a productive examination technique.

### *Consignments*

Retailers may receive as well as send out merchandise on consignment. Consignments of merchandise to others to sell are not sales since the title of merchandise remains with the consignor (Treas. Reg. section 1.471-1). It does not matter who holds possession of the merchandise. Therefore, if goods are shipped on consignment, the consignor (Retailer) 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.

Merchandise that is 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. Therefore, include in inventory goods out on consignment. Do not include in inventory goods received on consignment.

The examiner will question the retailer owner regarding items out on consignment at another location. Owners often display merchandise at malls, flea markets, and antique shows. Income from these sales should be included in gross receipts.

### *Sale of Accounts Receivables*

Many issues can arise from the sale of a business. Among them is how to handle the outstanding accounts receivables. The contract for sale must be secured and inspected in order to 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. Look to IRC sections 301(c) and 311(b).

### *Lottery*

Most state lotteries provide monthly activity reports to account for a retailer's lottery sales, commissions and bonuses.

Scratch off lottery tickets are usually purchased at a discount from the state representative, and then sold for \$1 each. In this case, all proceeds from the sales belong to the retailer, since the discount is the profit. In this case, the retailer pays out winnings, which are part of the discount computation.

Lottery or "lotto" machines installed in the retailer's store are provided by the state. When sales are made, the retailer collects the funds and the state withdraws the funds periodically from the retailer's bank account. In many cases the state will require a retailer to maintain a separate bank account for these funds. For calendar year taxpayers, the Form 1099 issued by the State Commission should be reconciled to lottery income reported.

### *Vending Machines*

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 will receive a monthly payment, but most likely the retailer will have a contract that pays a percentage of the receipts of the machines.

If the retailer owns the machines, the examiner can inspect the records for the periodic influx of coin currency. This would be the coins from the vending machines being deposited.

### *Bartering*

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 operates in much the same manner as a commercial bank. A business owner will complete a membership application, pay a fee and deposit 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 will publish periodic catalogs from which participants may also locate items. 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.

Bartering can also be done on a less formal basis by simply trading work with friendly business associates. In these cases the examiner must determine the extent of the bartering and ensure the value of goods provided is included in gross receipts.

## ***Cost of Goods Sold***

### ***Retail Inventory: IRM 4.43.1***

In all cases, a minimum inventory examination is required according the Internal Revenue Manual.

The cost of goods sold will be one of the largest dollar item expenses 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.

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.

### *Personal Consumption of Inventory*

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. There are several ways owners account for the inventory they personally consume. These include: (1) paying for their own inventory by writing personal checks, (2) account for their personal use by making adjusting entries in their books and records, (3) treat the amounts as "loans" to them from the business, (4) provided as "fringe benefits" to the owners, (5) consider them additional wages at the end of the year, or (6) not account for their personal use at all.

If the taxpayer indicated the inventory was paid for by personal check, verification of checks from the personal bank account would be in order. If the method of making adjusting entries was indicated, the accounting books and records should be verified as to whether they reflect this method. If the owner treated the amounts as loans, verify that interest is being accrued on the personal consumption account. In one situation, it was found that the shareholder of a retail store (a corporation) had used coupon checks received from a coupon redemption center to reduce his account balance of the corporate accounts receivable. This account was where the shareholder's personal use of inventory was posted.

If the amounts are treated as fringe benefits, verify they are added to the wages at the end of the year. In completing this verification, it would be advantageous to verify the payment plan used by related parties for payment of their personal retailer consumption. 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.

The arrangement by which the taxpayers treat the "purchase" of their own inventory may vary in scope. Consideration should also be made to purchases made by unrelated parties and the potential that a bartering situation exists.

### **Retail Inventory Method (RIM): IRM 4.43.1.3.1**

Retail operations may determine the cost, or the lower of cost or market, by using the retail inventory method (RIM). The RIM uses the relationship of retail price to cost to determine the cost of merchandise in inventory. The retail method is an averaging method and has historically been more convenient for most types of merchandise, especially as volume increases. If a perpetual inventory is also maintained, a retailer can determine profits, other than shrinkage, without taking frequent physical inventories. Grocery store operations primarily use the retail method of estimating the cost of inventories, as authorized by Treas. Reg. § 1.471-8. The use of such method must be designated on the return, accurate accounts must be kept, and the method must be consistently used. The retail inventory method takes the recorded sales for one year from the goods available for sale during that year to obtain the estimated closing inventory level at retail prices. Some uses of the retail method of estimating the cost of inventories are:

1. To 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, you can establish that the valuation of inventories is reasonable.
2. To estimate the cost of inventories for the tax years without taking physical inventories.
3. To permit the valuation of inventories when selling prices are the only available data. The use of this method allows the taxpayer to mark only the selling prices on the merchandise and eliminates the need for referring to specific purchase invoices.

4. To determine gross profits and operating income each month without taking a physical inventory.
5. A comparison of the computed inventory total with the physical inventory total, both at retail prices, will disclose the extent of inventory shortages and the consequent need for corrective measures.

Under the retail method, records are kept of goods available for sale at retail prices, and sales for the tax year are deducted from this total to determine the ending inventory at retail prices. The ending inventory valued at retail prices then is reduced to estimate average cost by multiplying the inventory at retail prices by the markup percentage computed for the tax year.

The following information must be accumulated in the accounting records to perform the necessary computations:

- A. The beginning inventory valued at both cost and retail amounts
- B. Net purchases priced at both cost and retail; and
- C. Net sales for the tax year.

Retail merchants are authorized to arrive at cost of inventories or the lower of cost or market by means of the "retail method." Under this method, the retail value of the closing inventory is reduced by a mark-on percentage; the difference is the cost or the lower of cost or market value of the closing inventory. The mark-on percentage is determined by:

- A. Subtracting the cost of opening inventory and purchases from
- B. The retail value of the opening inventory and purchases, and
- C. Dividing this difference by the amount arrived at in 2.

*Example:*

	<i>COST</i>	<i>RETAIL</i>
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 (*).....		<u>875</u>
Merchandise available for sale .....	<u>\$ 91,000</u>	<u>\$130,000</u>
Mark-up percentage (*) ( $\$91,000/\$130,000=70\%$ )		
Less: Net sales		<u>(90,000)</u>
Ending inventory, at retail .....		<u>\$ 40,000</u>
Ending inventory, at estimated average cost ( $\$40,000 \times 70\%$ )		\$ 28,000

The result should represent as accurately as possible the amounts added to the cost price of the goods to cover selling and other expenses of doing business and for the margin of profits.

If valuation at the lower of cost or market is desired, the adjustment is for mark-ups only. If valuation at cost is desired, the adjustment is both for mark-ups and markdowns.

If more than one department is maintained or the taxpayer deals in classes of goods carrying different percentages of gross profits, the mark-up percentage should be computed for each department or each class of goods.

Arbitrary markdowns for depreciation and obsolescence of the goods will be recognized only if the goods are actually offered to the customers at the prices so reduced.



The retail method may be used in conjunction with the last-in, first-out method of identifying the goods considered to be in the closing inventory. (However, if the retail method is used in conjunction with the LIFO method, the taxpayer must value its inventory at cost (i.e., lower of cost or market method is unavailable to the taxpayer).

The uniform capitalization rules per Internal Revenue Code Section 263A apply to the determination of cost of property purchased for resale, whether real or personal property, in the tax years beginning after 1986. The rules apply to retailers and wholesalers when they have average annual gross receipts for the preceding three tax years of \$10,000,000 or more. For a thorough explanation of the uniform capitalization rules and how they apply to retailers and wholesalers, refer to Treas. Reg. §§ 1.263A-1 and 1.263A-3.

### **Last In, First Out (LIFO): IRM 4.43.1.3.1.3**

Many larger retailers, such as auto sellers, will elect to use the dollar-value LIFO inventory valuation method. The use of the inventory price index valuation method is detailed at 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.

Computations of the retail LIFO inventory method are shown in the Internal Revenue Manual Retail Chapter of the Audit Techniques Handbook for Specialized Industries.

### **Stock Ledger (INVENTORY): IRM 4.43.1.3.2.5.4**

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 will also contain original entry information pertaining to the adjustment of the book inventory to the actual 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.

### **Point of Sale Perpetual Inventory Control System**

Retailers will use an automated retail system where the store cash registers are linked to computer processing systems. Merchandise is ticketed with colored bar code tags, which are read with wand readers at the checkout counter. The computer accumulates sales transaction information on magnetic tape for daily input into the computer memory bank or storage system. It is input into the sales journal, which is rolled up into the stock ledger.

### **[Valuation Of An Acquired Retailers Inventory \(PDF\) \(Coordinated Issue\)](#)**

When the comparative sales method of Rev. Proc. 77-12 is used as a basis for valuing a retailer's inventory, the cost of the reproduction method is less susceptible to error and therefore more appropriate to use than the comparative sales method.

If a taxpayer uses the "comparative sales" or "net realizable value" method, all expenses attributable to the disposition of the acquired inventory must be included in the taxpayer's computation, not just direct disposition costs. Consideration must also be given to the time that would be required to dispose of the inventory, the part of the expected selling price that is attributable to going concern and to a profit that is commensurate with the amount of investment and degree of risk.

In making the inventory value determination, the Service will take into account a fair division of the inventory profit between the seller and buyer of the bulk inventory.

### **Purchases**

Purchases will be one of the largest accounts on the income statement for a business with cost of goods sold. As with income, the Internal Revenue Manual requires an examination of each element of Cost of Goods Sold.

The examiner will select a sample period and conduct the following tests:

- Look for nondeductible expenditures in purchases.
- Scan the account for vendors not associated with the products or services handled by the taxpayer. For example, question the taxpayer regarding the purchase of bedroom furniture invoices found in the COGS for a convenience store.
- If the examination is extended to the owner's return, look for an absence of personal expenditures. For example, if the taxpayer's business is a retail grocery store, and no payments are made from the personal account for food purchases, consider personal withdrawals to the recipient.
- Scan the account for unusual payees and amounts.
- Test the purchases for a sample period with vendor's invoices and cancelled checks.

## Expenses

In addition to the personal consumption issue, review other expense accounts for personal items, including but not limited to, office expense, supplies, travel, meals, entertainment, vehicle, dues, etc.

### *Franchise Fees*

A retailer who purchases a franchise 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 on account of 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 Sec. 1253 for more information.

### *Cooperative Advertising*

For some retail businesses a manufacturer 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 take the full amount paid as advertising or (2) accrue the payment from the manufacturer at the time the "tearsheet" is mailed to the manufacturer. It was found that some of these retailers are reporting the payments on the cash basis.

### *Charitable Contributions and Promotions*

Many retail grocery businesses give money, inventory, and other donations to charitable organizations to promote their store's image and goodwill in the community. Some stores may deduct this as an advertising expense.

In other instances a retail business that purchased stock for holidays may discount the items after the holiday. If the holiday merchandise is still unsold after a second discount, the retailer may donate some or all of the holiday merchandise to a charity.

Generally the amount of a charitable deduction 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 (or, in other words, the retailer's basis in the item). For example, a retailer donates inventory to a qualified charitable organization, with 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. IRC 170(b).

A current trend is for grocery stores to allow volunteers to clip and place coupons on various products in the grocery store. These coupons would be marked or somehow identified as to the source of the coupon so that the grocer can readily identify which coupons are for the "charitable purpose." In turn, these products are sold to customers, who pay the full price for the product at the cash register. The retail grocer then submits the coupons to a clearinghouse that pays the grocers for all of the coupons being redeemed, including a handling fee. The grocer, after receiving the redemption check, pays the proceeds (either including the handling fee or not) to a charitable organization as its "service" to the volunteers who clip and place the coupons on the products. Many dollars are being paid to charitable organizations by these means. The examiner should be verifying that if the retail grocer

has implemented the above processes, that the payout procedures are being followed. Verify that the retailer is submitting all of these coupon redemption checks to the charitable organizations. Verify that the retailer is not retaining the handling fee portion of the redemption checks without reporting the amount as income. The examiner will have to make a determination as to whether this is an allowable contribution deduction per IRC § 170, or a promotion expense deduction allowable per IRC § 162. If the contributing retail grocer is a corporation, the contribution may be limited to a percentage of taxable income.

Another source of contributions by retail grocers is their inventory from the store. Inventory donated may include day-old bakery items, dented cans of food, old produce and other outdated items to food pantries and other charitable organizations. It is necessary for the examiner to identify the food being donated and to verify the contribution was actually made to the organization.

Verification of the food donation is important as it may be taken out of inventory without the appropriate write-off. Thus, it would be expensed at year-end, in addition to being written off as a charitable deduction, promotion expense, or food spoilage. Food being written off in this way may also be a way for the grocer to disguise personal groceries.

When an examiner is looking into the area of charitable contributions of retailers, consider not only verifying the deduction to see if the deduction is allowable, but make sure the procedures the retailer explained, actually did occur.

Ordinarily, charitable deductions for inventory items are limited to basis (see the example above). A special rule, however, provides for a larger deduction for C-corporations that contribute food inventory, if certain requirements are met, under Section 170 (e) (3). One of the requirements is that the property must be used by the charitable donee solely for the care of the ill, needy, or infants. Treas. Reg. Sec. 1.170A-4A.

If this section applies, the deduction is equal to the basis of the property contributed plus one half of the appreciation, not to exceed twice the basis. The amount would be treated as a contribution and cost of goods sold would be reduced by the amount of the contribution.

#### *Accruals*

Inspection of end-of-year accruals should be made to ensure proper cutoffs were made in compliance with IRC § 441 (period for computation of taxable income). In the case of any taxpayer who has made the election provided by IRC § 441(f), the fiscal year could be the annual period, varying from 52 to 53 weeks, if so elected. For example, stores may be turning in weekly sales and expense reports for accounting purposes. At year-end the accounting service may be cutting off the year as of the last day of the weekly report. However, the last day of the weekly report may be December 29, 30, 31, January 1, 2, 3 etc., and does not coincide with the stores tax year. This is particularly true when the wholesaler is providing the accounting service, and someone else prepares the tax return.

#### *Depreciation and Cost Segregation see [Cost Segregation ATG](#)*

Buildings that are owned by the business can be depreciated under the Modified Accelerated Cost Recovery System (MACRS) for 39 years. Some elements of buildings, however, can be separated and identified as tangible personal property. This practice is called cost segregation, which allows recovery of the personal property elements of a building over a five-year period using the 200-percent declining balance method. The personal property elements qualify for IRC section 179 expense deductions and bonus depreciation under IRC section 168(k). This separate valuation of real and personal property can also reduce state and local taxes imposed on real property.

The portions of the building that are classified as structural components are considered real property and are included in the depreciable basis. The portions of the building that are classified as personal property are separately depreciated.

## Depreciation and Cost Segregation Studies Update:

### *Cost Segregation ATG:*

A cross functional team developed an Audit Technique Guide (ATG) for the preparation and examination of cost segregation studies. The primary goal is to provide examiners with an understanding of why cost segregation studies are performed by taxpayers, how such studies are prepared, and what to look for in the review and examination of these studies. This guide will also assist taxpayers and practitioners in understanding some of the items the Service will consider to support property allocations based on these studies.

It should be noted that this ATG is not an official Service pronouncement and may not be cited as authority.

### *Field Directive on the Planning and Examination of Cost Segregation Issues in the Restaurant Industry:*

A joint SB/SE and LMSB Industry Directive for the depreciation classification of various assets in the restaurant industry was issued on December 8, 2003 and it was updated on December 27, 2004. The new guidelines provide guidance on the determination of whether restaurant assets are IRC Section 1245 property (shorter cost recovery period) or Section 1250 property (longer cost recovery period) property. Prior to this guidance, there had been some controversy on audits as to the appropriate recovery periods used in computing the depreciation deduction for certain depreciable assets.

The IRS issued this Industry Directive after soliciting input from IRS examiners, the restaurant industry, and the practitioner community. The anticipated benefits of the guidance include reducing costs and burden for both taxpayers and the IRS since the Directive should lesson some areas of disagreement regarding tax treatments of certain restaurant assets. Although Industry Directives are not official pronouncements of the law or the IRS's position, their purpose is to provide guidelines on the efficient use of audit time and resources.

IRS has instructed examiners not to make adjustments to the categorization and lives of the asset if a taxpayer's classification is consistent with the recommendations in the Industry Directive.

### [Suspended Acoustical Ceilings \(PDF\) \(Coordinated Issue\)](#)

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. The regulations, revenue rulings and court cases previously cited, all point to the fact that suspended acoustical ceilings are structural components ineligible for classification as Section 1245 property, and do not qualify for the ACRS deduction as 3 or 5-year property or for the investment tax credit.

### [Heating, Ventilating and Air Conditioning \(HVAC\) In Grocery Stores \(PDF\) \(Coordinated Issue\)](#)

It is the position of the Internal Revenue Service that HVAC units located in retail grocery stores or supermarkets which service the building as well as the freezers and refrigerators within the store are structural components of the building since they fail to meet the "sole justification" test specified in the regulations. The HVAC units are not Section 38 property and do not qualify for either the investment tax credit or the ACRS 3 and 5-year recover categories.

## **Excise Tax Issues**

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 section 4161(a) imposes a tax on the sale of articles of sport fishing equipment specifically enumerated in IRC section 4162, including any parts or accessories of the article sold on or in connection therewith or with the sale thereof. IRC section 4161(b) imposes a tax on bows, certain bow parts and accessories, certain quivers, and certain arrow components.

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

The examiner should be alert to employment tax issues between family members and a retail store business.

Consideration should also be given as to whether “contract labor” or fringe benefits are taxable to the recipient. Some businesses set up temporary stores in various locations and utilize individuals who are regular employees to organize and set up these stores. The payments to these individuals are sometimes classified as other expense, set up expense, contract labor, travel, etc., but if the services are performed by employees, this compensation should be included in the Form W-2 wages. If the payments are, in fact, to independent contractors who come in and set up the store, verify that Form 1099 has been filed.

If an employment tax issue is raised, Section 530 and CSP must be considered.

Any retail business can be largely a cash business. As a result, many owners pay people for services rendered in cash. Two areas to consider in auditing these entities are cash paid to employees and cash paid to vendors. Make sure the cash paid to the employees have employment taxes paid on it. The cash paid to vendors must be reported to the vendors on Form 1099.

In the Restaurant and bar industry another area involves the requirement that the tipped employees in the establishment report their tips received to the employer at least monthly. The Omnibus Budget Reconciliation Act of 1987, revised IRC section 3121(q) to require the Employer to match the FICA Taxes of the employee for tips reported.

Remember when opening an employment tax examination, other return statutes need to be protected. A Form SS-10 would be required for employment tax in addition to the appropriate Form 872 or Form 872A for income tax.

# Chapter 3: Examination Techniques for Specific Industries

## *Electronic Business, Online Retail*

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### Introduction

Electronic business (E-Business) encompasses a wide range of emerging and evolving concepts and technologies. Generally, 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. In retail businesses the examiner is likely to find that retailers make a substantial percentage of their purchases of goods and supplies online

Retail e-business sales for 2003 were \$55 billion, according to the U.S. Department of Commerce. 2004 has again seen a dramatic increase in online retail sales increasing to nearly \$69 billion. There are a significant number of Small Business/Self-Employed taxpayers involved in online retail, including Catalog and Mail Order Sales of Automobiles & Parts, Specialty Items, Music, Videos, Books & Magazines, Electronics & Appliances, Computer Hardware & Software, and Clothing.

With the increased awareness and popularity of the Internet, individuals and businesses, both large and small can participate in e-business. The Internet is changing the way that many retailers conduct their business. Retailers are now involved in multi-channeling to a greater extent; whereby a portion of the business is still conducted at the traditional “brick and mortar” establishment and also business is conducted on the Internet becoming “click and mortar” businesses. Many retail and service businesses use the Internet for advertising for their traditional businesses in which the sales transaction of the product or service cannot be or is not consummated online.

As the influence of the Internet grows, conducting business-to-business commerce on the Internet will expand greatly, and become more of a routine part of commerce than it is today. Even small businesses are increasingly utilizing the Internet to conduct business transactions. This increase in rate of electronic business promises to be faster than any other technological innovation to date and its implications far more profound.

Online Retail Sales have shown a significant growth of 243 percent for the period 2000 through 2004, with sales of \$28.3 billion in 2000, rising to \$68.9 billion through 2004. (Source: U.S. Department of Commerce Census Bureau.)

### Internet Investigative Tools

How does the examiner know if the taxpayer is involved in e-business or has a web site? There is no definitive means of determining whether or not a taxpayer is involved in e-business. Here are some suggested audit techniques to help make that determination:

1. Ask the taxpayer if he/she has a web site. Use a search engine.
2. Most businesses want high visibility to reach customers and will register their site with the major search engines.
3. Look in the yellow pages to see if the taxpayer advertises a website.
4. Business cards will often have the name of a website on it or an e-mail address. If the domain name included in the e-mail address is similar to the taxpayer's business name, then it is very likely the taxpayer has a business web site.
5. Look for deductions that are common for e-business:
  - Website development costs paid for software used to create a website or to an application service provider.

- Larger than normal depreciation deductions for web servers, networking equipment, and payments to Internet access providers.

The examiner of a retail business should always consult the Internet for possible websites or links to the business under examination or to unknown businesses belonging to the taxpayer. ***Inspection of the taxpayer's website is every bit as important as the inspection of the place of business.*** Internet Investigative Tools are available to assist examiners in their examinations. What can these tools do for the Revenue Agent? After the agent has determined an Internet presence for the business or promotion the agent will be able to identify possible third-party contacts to be made and related websites and other possible businesses and relationships.

- **Ask** the taxpayer. This question must be asked during the Initial Interview.
- Perform Google searches for the Domain Name based on the business and individual names.
- Save the current website content using Internet Explorer. Saving the website content before the taxpayer closes it down or places security on it such as "members only" registration is important to the development of an unreported income case involving online retail sales.
- Perform a **LinkPopularity** search to determine linked websites, related websites and other websites under the control of the taxpayer to determine other possible sources of income for summons action.
- Use **Whois** to locate the Registrar and summons records.
- Use **Whois** to locate the Responsible Party and summons records

Search the Internet Archives Wayback Machine.\*

(\*The Internet Archive is a database of archived webpages dating back to 1996. The search interface for the Internet Archive is the Wayback Machine. Using the Wayback Machine, it is possible to search for the taxpayer's website. 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 historical information. Did the online business really start in 2004 or was there activity prior to that year? What were the product lines that were being sold online during the year of audit? Are those product sales included in income?)

## **Audit Techniques & Interview Questions**

### *E-Business Online Retail & Services Interview Questionnaire*

1. Do you have an Internet presence? (web site, web page, e-mail, banner for business purposes)
2. Do you conduct business transactions over the Internet? (Accept orders and/or payments over the Internet?) (What types of records are maintained for these transactions? All electronic? Paper documents?)
3. What products, services or memberships may be purchased on your web site or through the use of email?
4. When was the web site "opened" for business? Did the business exist prior to creation of the web site? Is the business conducted over the Internet separate or distinct from the taxpayer's historic line of business?
5. What domain names have been registered either by you or on your behalf? What domain names do you have control over? Please include the date of registration and the name of the registrant.
6. How is the fee for Internet connection services determined?
7. How was your Internet web site developed, i.e. outside consultant, internal staff, web site design software? Details regarding all consulting fees, employee salaries, design software, etc. should be requested.
8. How many employees are engaged in the Internet-based business activity? Secure a list of the employees, job titles, compensation, etc., responsible for web site design and web site hosting.
9. How much has the taxpayer paid to outside vendors including non-employee compensation, for web site development and web site hosting?
10. What type of credit cards does your financial institution(s) accommodate?
11. What is the name of the financial institution(s) that clears your credit card receipts? Was an application or merchant services sign-up form completed for the credit card clearing services?
12. Does your ISP or the entity that is providing you server space process your credit card transactions?
13. Have you used any other financial institutions in conjunction with your web site?
14. Does your financial institution(s) provide:
  - charge authorization

- transaction capture
  - settlement
  - charge-back handling
  - reconciliation
  - reporting, or
  - Prepaid card issuance and acceptance?
15. 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.
  16. How are credit sales handled and how are they recorded in gross receipts?
  17. How are non-credit sales handled and how are they recorded in gross receipts?
  18. How is information for approved or authorized credit card product purchases processed?
  19. What is the sequence from order entry to shipment?
  20. How are products shipped and which shippers are used?
  21. Who are your major suppliers and vendors?
  22. From where are shipments made?
  23. Do you have any paid referral or advertising contracts with other Internet web sites? If the answer is yes, obtain copies of the contracts.
  24. Do you swap (barter) links, banner space and server space with any other businesses?
  25. Do you have any foreign operations?
  26. Do you have direct or indirect control over any foreign corporations, foreign partnerships, foreign trusts or any other foreign business enterprises?
  27. Do you have any direct or indirect control over foreign bank or other offshore accounts?

**Identification of E-Business Cases:**

When you are first assigned a return for examination, you may not immediately know 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 one of the gTLDs (e.g. .com, .net, etc.) 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.

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 indicated to be based on the North American Industry Classification System (NAICS). E-Business returns may be identified using NAICS.

<b>Forms</b>	<b>NAIC Code</b>	<b>Explanation of Business or Products</b>
1120, 1065, 1120S, 1040/C	425110	B2B Electronic Markets
	454110	Electronic Shopping & Mail Order Houses
	511210	Software Publishers
	516110	Internet Publishing & Broadcasting
	518111	Internet Service Providers
	518112	Web Search Portals
	518210	Data Processing, Hosting & Related Svcs
	541511	Custom Computer Programming Services



<b>Forms</b>	<b>NAIC Code</b>	<b>Explanation of Business or Products</b>
	541512	Computer Systems Design Services
	541513	Computer Facilities Management Svcs
	541519	Other Computer Related Services
1040/C-Only	519100	Other Information Svcs (News, Synd, Lib)
	454112	Electronic Auctions
	454111	Electronic Shopping

Expenses contained in the Other Deductions line item may provide indicators of Internet activity. Below is a list of expenses that a business with a website might deduct:

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

Many tax returns contain a supplemental depreciation schedule. Assets included on the depreciation schedule may also indicate that the business is involved in the Internet. 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

An unusually large amount deducted for Rental/Leasing Expense and/or Utilities may also be indicators that the company is involved in Internet activity. Many taxpayers do not have the capital necessary to fund the initial investment for equipment and peripherals needed for Internet activity. These taxpayers rent or lease the equipment and peripherals as an alternative.

More and more traditional brick & mortar” businesses in the retail and services trade are turning to the Internet as another market and becoming what is referred to as “click and mortar” businesses, combining their traditional business activities with the virtual world of the Internet. This may not be obvious to the examiner upon review of the return during the pre-planning stages.

If there are no indicators on the return or if the indicators are not conclusive, other references may also indicate that the taxpayer is involved in e-business. A Yellow Pages ad, for example, may list a web address. A company with a web site will usually include the address in their advertising, brochures or pamphlets, signs on the building, business cards, company letterhead, vehicles, and receipts or invoices. A Google search for the business is also an excellent pre-planning tool to determine whether the taxpayer is involved in online sales or services. More advanced searches are recommended to identify all websites used by the taxpayer and business.

Once the audit has started, the most obvious way to find out if the taxpayer is involved in e-business is to ask. It is important to ask even if there are no indicators of an online presence for the taxpayer. See the recommended Interview Questionnaire and the Explanation for the questions in the chapter Appendix.

## Income

The potential for omitted income is greater in E-Business, due to the borderless and paperless feature of the organization. Another large segment of E-business transactions is internet bartering.

The examiner should question the taxpayer for the procedure when a sale of a product is conducted on the taxpayer's website, for example, can the order be placed on-line and payment submitted on-line? What type of payment is the taxpayer accepting if sales are occurring on the Internet? How can the examiner verify that all sales are being reported? The examiner must determine if the business offers its clients the opportunity to purchase directly from a web-based catalog. "Walk me through various types of transactions."

It is important for the examiner to review the taxpayer's web-pages for **E-payment** sources such as PayPal, Visa and MasterCard, 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 there but are missing. Evidence of an unreported online business can also be found by tracing credit card payments or following up on invoices providers.

Any business that operates a website will receive advertising income for banner ads and pop-up ads that appear on their website. Additionally, each time a site visitor clicks onto the ad, another fee is paid to the site owner. Be sure to ask how this income is accounted for. Many times there is a counter on the site that indicates the number of visitors to the site that would give the examiner an idea of the amount of traffic the web site receives. If the examiner can determine the "click-through" rate charged, a good estimate of this income can be made. (Often this rate is between 5 and 10 cents per click.)

With online retail, the reconciliation of shipment costs with both COGS and Income is another quality audit technique. The examiner should consider the average mark-up based on purchases reported and not reported to identify any unreported income. The Percentage Mark-up Technique for the determination of Income based on Cost of Goods Sold Purchases should be considered and employed when appropriate.

Point-of-Sale software issues (ZAPPER) and the fact that taxpayers have the ability to edit tax and accounting records in most versions of commercially available software are discussed elsewhere in this guide. Needless to say, examiners must be vigilant for any indications of income or expense record manipulation by the taxpayer.

## Cost of Goods Sold

Cost of goods sold will not differ significantly for businesses involved in e-business. Since there is no fixed location, shipping costs will be evident and the examiner should question the taxpayer regarding the method (FedEx, USPS, UPS, etc.). Another clue to business-to-business internet purchasing is when the 'ship to' address is different from the 'purchaser address'. This is indicative of a more complex business structure that could involve a possible Offshore aspect to the examination. Any Offshore issues involving Online Retail should be referred to the E-Business & Emerging Issues staff for assistance.

## Expenses

Some expenses of an online retail business will be different, but the same tax laws apply as those for a traditional retail establishment.

Online Purchases and Expenses present a challenge as usually there is no evidence other than the electronic document, which can be easily manipulated. Electronic records should be tested for accuracy and any adjusting entries scrutinized. If the books and records appear questionable and Internal Control is lacking, the examiner should consider third-party contact for significant and/or reoccurring expense items.

## ***Potential Tax Issues***

- Not a trade or business – When a taxpayer has claimed losses over several years from online retail activity which was used to shelter ordinary income from other sources, a determination should be made whether this activity is a business or a hobby. These losses often stem from abusive deductions for expenses such as auto expenses, travel, and in home office allocations. Allowance of these items is questionable under several IRC Code sections including sections 162, 183, and 262. (Home-based business)
- Tax Shelter – Similar to the above scenario, except that we have identified a systematic scheme to obtain losses and credits that are not allowable under IRC sections 162 and 44. (ADA Credit for Website Improvements)
- Cost of Goods Sold - Revenue Procedure 2000-22 excepts qualifying taxpayers with average annual gross receipts of \$1,000,000 or less from the requirements to account for inventories. However, if a taxpayer decides not to account for inventories, the taxpayer is required to treat what would have been treated as inventory as a material or supply that is not incidental under Treasury Regulation section 1.162-3. The result is that the deduction is deferred until the material or supply is consumed or sold. This is a potential issue for online retail.
- Failure to Report or Failure to File – Information available indicates that the taxpayer has an online retail site, but the examiner cannot ascertain how the proceeds were reported. There is no Schedule C, Partnership, or Corporate filing that has been identified or the taxpayer is a nonfiler. An examination must be conducted to determine tax liability using Indirect Methods and Third-party Contacts and Summonses.
- Omitted Online Retail Sales for an established “brick & mortar” business. One easy way to understate income is to not recognize an entire income stream such as the online retail segment of an established traditional retail business. Segregated income streams are easily concealed by diversion. This is an example of the importance of using Internet Investigative Tools to determine whether a traditional retail business has expanded into an Internet presence. Techniques discussed earlier in this chapter will be required to develop the case.
- Use of Limited Liability Companies and Trusts structures and no 1040 returns filed. This scheme has been identified in the field involving online retail and online services businesses. An LLC is formed as the business entity for the online retail business, with Grantor Trust Partners creating a TEFRA partnership at the LLC level. The individuals involved in the business do not file 1040 returns.
- The tax treatment of the following items may result in potential tax issues. Many of these potential issues boil down to capitalization versus expensing and timing of deductions. The tax treatment of these items is still under consideration by Counsel and issues involving the tax treatment of these items and online retail should be referred to the E-Business & Emerging Issues staff for assistance.
  - Business Start-up Costs (Internet Business)
  - Acquisition of Domain Name(s) and Website Development Costs
  - 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
  - Research & Experimental Expenditures and Credit

## **Summons Resources for Online Retail Case Development**

During the course of an examination of an online retail taxpayer, it may be necessary to issue summonses to third parties. Suggested summons language for Responsible Parties, Registrars, Internet Service Providers, Internet Access Providers, Credit Card Companies, PayPal and Other E-Payment Providers is available on the E-Business & Emerging Issues website.

## Glossary

**ARIN** American Registry for Internet Numbers

**B2B** Business to business transactions, such as making online purchases from supplier.

**B2C** Business to consumer transactions, such as when a consumer makes an online purchase from a business website.

**Bridge** A device linking Local Area Networks (LAN) together or two segments of the same LAN.

**Broadband** A type of transmission where a single medium (typically fiber optic) can carry several channels at once.

**FTP** File Transfer Protocol.

**Gateway** A device linking LANs that may be using different networking protocols to communicate

**HTML** Hypertext Markup Language

**ICANN** Internet Corporation for Assigned Names and Numbers

**IP** Internet protocol

**Terminal Server** A point of access to a network. Also called remote access servers.

**WWW** World wide web.

## EXHIBIT 1: E-Business

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

1. Do you have an Internet presence? (web site, web page, e-mail, banner for business purposes)

**Explanation** – It is important to determine the extent of the taxpayer’s involvement with the Internet. Keep in mind that a web presence does not necessarily mean that the taxpayer 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.

2. Do you conduct business transactions over the Internet? (Accept orders and/or payments over the Internet?) (What types of records are maintained for these transactions? All electronic? Paper documents?)

**Explanation** – The examiner will need to determine the nature of business transacted as well as the volume and types of records maintained for examination.

3. What products, services or memberships may be purchased on your web site or through the use of email?

**Explanation** - The interview process often provides leads that are very valuable to checking and verifying reported income later when you are examining the actual books and records. For example the taxpayer may describe a list of products a, b, c, d & e. Yet when you are looking through inventory records you may only see a, b, & c on hand. Maybe you are auditing the 2003 tax year and the taxpayer did not start selling d & e until 2004, or maybe they omitted the sales of these particular items from their tax return.

4. When was the web site "opened" for business? Did the business exist prior to creation of the web site? Is the business conducted over the Internet separate or distinct from the taxpayer's historic line of business?

**Explanation** – How you audit a business depends in significant part on what was 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?

An important first step in this regard is to establish the date that the web site became operational. The date the taxpayer obtained their domain name may coincide with the date the web site opened for business. Invoices from paid consultants or purchases of software, and service dates on bills from the taxpayer's Internet Service Provider (ISP) are all indicators as to when a web site became operational or there was a significant upgrade in the capabilities of the web site to offer interactive business services.

5. What domain names have been registered either by you or on your behalf? What domain names do you have control over? Please include the date of registration and the name of the registrant.

**Explanation** - The domain name is the web site address used to find the site on the Internet. As a revenue agent, you already know the importance of conducting a tour of a business. If you were auditing the XYZ chain of bookstores, you would look to see the addresses of the separate bookstores, how many cash registers each had, etc. Each web site is just like a separate bookstore in the physical world with a separate cash register. In the world of electronic business, each domain name gives the taxpayer a storefront with its own unique cash register. Identifying the number of web sites a taxpayer has is no different than trying to identify all the possible business sites or cash generators on your tour of a more earthbound business.

Domain name information can be obtained from InterNic. InterNic is the directory service under contract with 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. Domain names may be acquired from domain name brokers. Third party domain name brokers gang register domain names with InterNic for a nominal fee on the speculation that the name may appreciate in value. The resale value may exceed several hundred or even several thousand dollars. These names are tentatively believed to be capital in nature with the cost being amortizable.

6. How is the fee for Internet connection services determined?

**Explanation** - The stock reply from the taxpayer is "From the bill." However, the answer we are looking for 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 taxpayer is paying for basic point of presence (POP) on the Internet.

A volume-based fee is based upon what is known as bandwidth and storage volume. You can have either or both together. 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. This is accomplished by expanding bandwidth. Therefore, a large bandwidth implies a high volume web site.

Storage volume is associated with the sophistication of the web site. The web site 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 web site, the more storage space is required when someone accesses the web site.

In addition to bandwidth and storage, volume-based billing may also include charges for other ancillary services. These may involve special routines such computer graphics interchange (CGI) 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 web site implies a higher volume of business.

7. How was your Internet web site developed, i.e. outside consultant, internal staff, web site design software? Details regarding all consulting fees, employee salaries, design software, etc. should be

requested.

**Explanation** - The proper tax treatment of web site development costs is the subject of controversy. Should web site development costs be expensed or capitalized? Should the costs be aggregated into one intangible asset and amortized over a period of time? Alternatively, should pre-Internet precedents be applied that would permit expensing some of the web site costs like software, and capitalizing others such as logo and trademark expenditures? It is important to quantify the various categories of web site design costs. See Questions 8 & 9 for additional discussion.

8. How many employees are engaged in the Internet-based business activity? Secure a list of the employees, job titles, compensation, etc., responsible for web site design and web site hosting.

**Explanation** - Many Internet based businesses, especially startup companies are “sweat equity” or “bootstrap” operations. The taxpayer may do much or most of their own web site 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.

9. How much has the taxpayer paid to outside vendors including non-employee compensation, for web site development and web site hosting?

**Explanation** - As with question 8, we are seeking to identify and quantify the costs of web design versus hosting. Be alert in this area to issues associated with Form 1099 compliance and employment tax.

10. What type of credit cards does your financial institution(s) accommodate?

**Explanation** - An Internet business can accept various credit cards from various sources and have them processed through multiple financial intermediaries. We cannot emphasize enough the need to examine this area in detail. Our experience to date indicates that the diversion of credit card receipts is the primary vehicle for underreporting income on the Internet. A flow chart of the transactions through the system, especially the interface between the web site and the accounting records is a useful tool in identifying “leakage” of receipts from the system.

11. What is the name of the financial institution(s) that clears your credit card receipts? Was an application or merchant services sign-up form completed for the credit card clearing services?

**Explanation** - There is a wealth of information on the sign-up form. Ask to see copies of all the form(s). In addition to the names of the financial institution, make note of the following: a) the account numbers, b) dates opened and closed, c) changes in financial institutions.

In most 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 utilize the services of a local bank. The typical flow of transactions is as follows: the merchant deposits the credit card slips to its account, the bank posts the deposit to the credit card processing account, and then as a transfer deposit to the merchant’s checking account.

There are no geographic limits on the Internet and the connection with the local financial community may be minimal for an Internet-based business. Banking and credit card relationships may be fractionalized on the Internet. For example, company A in New York 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 could be located anywhere in the world. One typical scenario is to have 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. The lesson here is that on the Internet 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.

12. Does your ISP or the entity that is providing you server space process your credit card transactions?

**Explanation** - There are a number of web site hosting services that will provide a free web site in exchange for the exclusive right to process the credit card transactions originating with that web site.

13. Have you used any other financial institutions in conjunction with your web site? If yes, secure the same information discussed under question # 11.
14. Does your financial institution(s) provide:
- charge authorization
  - transaction capture
  - settlement
  - charge-back handling
  - reconciliation
  - reporting, or
  - prepaid card issuance and acceptance

**Explanation** - This shopping list refers to various features that a particular financial institution may provide to a typical merchant. Charge authorization establishes that a hold is placed on a customer account at the time of order to minimize sales in excess of the credit limit. Transaction capture refers to the process of recording the actual sales transaction for the merchant. Settlement refers to the actual transfer of funds to the merchant's account in settlement of the customer charge. Charge-back handling refers to the situation where a customer objects to a particular billing. This amount is then "charged back" or offset against the merchant's other settlements. Reconciliation involves the process of clearly establishing the sources and payment of sales to the actual settlement remittances provided to the merchant. Reporting is the provision of statements detailing sales activity. 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.

15. 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.

**Explanation** - This is an area that is changing on an almost daily basis. In order to process a payment from an Internet web site a special type of software must be in place. It utilizes the security aspects of Secure Socket Layer (SSL) type technology to make sure that credit card data can not be intercepted by anyone on the Internet. There are a number of retail software packages that enable a site to conduct business. Many of the newer ones use a turnkey, "load the software and you're in business" type approach. For a minimal fee, the software vendor will handle the actual sales activity.

16. How are credit sales handled and how are they recorded in gross receipts?

**Explanation**- This is merely what you would do in any physical business audit. However, with an Internet based sales operation the various pieces can be very far flung and can change several times as the merchant experiments with alternative sources and institutions.

17. How are non-credit sales handled and how are they recorded in gross receipts

**Explanation** - Are transactions that are paid for using check, e-check, money order, or even cash handled differently than credit card sales?

18. How is information for approved or authorized credit card product purchases processed?

**Explanation** -This question is designed to address the actual steps utilized in approving and authorizing a customer credit card number for a purchase from a commercial web site. In a typical (non-Internet based) business you go into the store present your card and the merchant runs it through a machine that reads it or prepares a document. A deposit is then automatically made to his previously approved bank account. An Internet based company only needs the card number and the expiration date to process your purchase. A personal name may not be required to process the transaction online.

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 just like you would for any business. The monthly processing cycles, deposit periods, and holdbacks may affect the proper reporting of income depending on the taxpayer's method of accounting.

19. What is the sequence from order entry to shipment?

**Explanation** - This question is a follow-on to question number 18. The answer to this question will tell such things as to when income should be accrued, inventory is relieved, and items are actually shipped. It will allow you to establish the cutoff periods that should be used in the books. The purpose of flowcharting (a.k.a. system walkthrough) and documenting (verifying audit trail) all the steps in the process is to ascertain the degree of correspondence between the physical flow of goods and services, and the taxpayer's method of accounting. In addition to determining whether the taxpayer is using a proper method of accounting, the walkthrough may identify weaknesses in internal control that would warrant an adjustment to the scope of the audit plan for sales and cost of goods.

20. How are products shipped and which shippers are used?

**Explanation** - This question is meant to address purchases of the taxpayer's product by the ultimate consumer. Companies use many different shippers and common carriers. Some of the ones that are frequently utilized by Internet based companies include the U.S. Postal Service, FedEx, UPS, etc.

Several useful pieces of information may be garnered from shipping records. First, the total cost of "freight out" is indicative of the total volume of sales. Second, the information on shipping can assist with inventory related questions such as:

- consignments
- relief or reduction of inventory at year end
- timing of inventory reductions
- when title passes, and
- reimbursement for insurance, shipping and handling costs.
- Finally, the shipment records can be used as an "independent third party" for internal control and verifying income reported.

21. Who are your major suppliers and vendors?

**Explanation** - It is suggested that you document a list of product vendors from whom the business buys as a means to check sales and inventory. Look for vendors that are selling items that do not fit the profile of the taxpayer's type of business.

22. From where are shipments made?

**Explanation** - Unlike traditional businesses, Internet-based companies may not ship out of a warehouse that is co-located with the rest of the business. In fact, the 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 particular customer. 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, the identification of items "dropped shipped" from foreign sources to foreign destinations may indicate the existence of unreported foreign source income.

23. Do you have any paid referral or advertising contracts with other Internet web sites? If the answer is yes, obtain copies of the contracts.

**Explanation** - A business may pay other web site 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 web site. Alternatively, it may be based upon a certain percentage of the sales resulting from customers referred from the originating web sites.



Ideally, the referral or advertising contract will describe the relationship and payment terms. However, do not be surprised if the “contract” does not contain all the signatures and legal niceties that are the hallmarks of a valid contract. Many contracts on the Internet are relatively informal affairs. It 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 with the deal being consummated by an exchange of e-mails between businesses hundreds of miles apart.

There are audit techniques that may be utilized to ascertain how many “click throughs” may have originated from a particular source site during a given period of time. These methods require access to the ISP’s server log, the ISP’s periodic operational data backups, as well as the taxpayer’s “statistics directory”. The latter may be found among the web site 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 could be contacted for information on the volume of referrals.

Two additional limitations regarding this technique merit comment. First, web sites can change frequently and current information available on line may have absolutely no relevance to the year under audit. ISPs usually do not retain these types of records for long periods.

Second, since this information is largely circumstantial, except for the identification of the number of web site hits, it is the revenue agent’s responsibility to evaluate the merits of pursuing this line of inquiry in light of RRA ’98’s prohibitions against excessively intrusive audits and economic reality-type income probes.

While “advertising contracts” may or may not exist, payment will. Payment may be in the form of check, electronic funds transfer, or online bank check. The old collection axiom of “follow the money” is probably most appropriate. If we have a payment for advertising, we have a payee. If we have a payee, we have a payer with one or more of the following obligations: 1) to identify the payee as a party not subject to backup withholding, 2) to obtain the taxpayer identification number of the payee and 3) to issue Forms 1099. If the payer is remiss in his reporting responsibilities, the back-up withholding may be assessed. The current back-up withholding rate is 31 percent.

24. Do you swap (barter) links, banner space and server space with any other businesses?

**Explanation** – This is a follow-on to question number 21. A link is simply a highlighted spot on a web page. When you click on the link it brings you to another web site. A link may be a highlighted name or a picture. In designing a page the webmaster chooses whether the link will be text or a picture.

A banner is similar in function to a link. Its purpose is to bring you to the web site of the advertiser. In general, banners are larger than simple text links. They frequently occupy the top fifth of the page, or extend down the side. A banner is designed to function as a kind of interactive electronic billboard. It is designed to attract attention. The most common form of bartering on the Internet involves the swap of banner space. Two businesses will place banners on each other’s web site in order to develop some synergy between the two web sites.

Recall our earlier discussion regarding the role of a host computer in supporting a web site. In general, a taxpayer’s web site is not resident on the taxpayer’s computer, but it is electronically (physically) located on a host computer owned by an ISP. The only exception is a taxpayer that owns its own host computer. The web site’s host computer is called the server.

The issue in the instant case is whether something or some service is being swapped for server space. For example, a company may provide server space in exchange for banner space on the web site, the right to process credit card transactions originating from the web site, or product.

What are the tax implications of all of these transactions? It is entirely likely that your taxpayer may tell you that they received this link, banner or server space for free. This is becoming more commonplace as costs have dropped dramatically. The reason for the practice is that it is done to increase site visitors, hits and page views. The Internet is a linked community. It is helpful to consider the fair market value of what

is being bartered when considering the potential tax effect of these transactions. Fair market value is what someone else would pay for that space on your taxpayer's web site in an arm's-length transaction.

Storage space can be purchased in the open market for less than a penny per megabyte using hard drive storage cartridges that contain up to 2.6 gigabytes of information that sell for \$35 each. File size of a graphical banner ad with animation could take up almost a megabyte of space itself on a host's server. Is the cost of the server space the FMV? Not necessarily, cost is usually equivalent to fair market value. What really determines fair market value of a banner ad is the popularity of the web site it is on. If you are selling auto insurance, your banner will be worth a lot more if it is located on a web site hosted by large auto dealership in comparison with the web site operated by XYZ's Junk Yard.

25. Do you have any foreign operations?

**Explanation** – We are not restricting our concept of foreign operations to activities that require a physical presence in a foreign country. The Internet and electronic commerce transcend the limits of geography. It has created an era of micro-multinational corporations. If your taxpayer has extensive foreign sales or investments, you should consider requesting the assistance of an International Examiner. Form 2962 may be used to request the assistance of an International Examiner.

26. Do you have direct or indirect control over any foreign corporations, foreign partnerships, foreign trusts or any other foreign business enterprises

**Explanation** – Sometimes to facilitate operations and financial activity a business here may set up foreign corporations, foreign trusts etc. If you can identify any of these foreign entities as existing then you can possibly obtain or request the foreign return documents filed by the taxpayer for these entities. Again, the involvement of an International Examiner should be considered.

27. Do you have any direct or indirect control over foreign bank or other offshore accounts?

**Explanation** - If there are any indications of foreign bank accounts the taxpayer may be liable for filing Treasury Form 90-22.1 (FBAR) (this is not an IRS form). Failure to file the form may subject the person to a penalty under Title 31. These forms apply to situations where there is more than \$10,000 on deposit at ANYTIME during the course of the year. The income tax return contains a check off block in which the taxpayer must affirmatively attest to the presence or existence of foreign bank accounts. Past experience has shown that failure to disclose the existence of foreign bank accounts can in appropriate circumstances be held to constitute the filing of a false income tax return when combined with other factors.

## ***Video/DVD Rental Business***

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### **Introduction**

The video/DVD industry is partially made up of taxpayers who want to establish a store to rent video/DVDs to the public. These "mom and pop" stores are present in both metropolitan and rural areas. The size of these non-franchised businesses will generally run from gross receipts of \$25,000 to \$500,000. The taxpayer purchases mass-produced copies of master versions of movies in the video/DVD format.

### **Income**

Small rental activities are sometimes a sideline business in a grocery or convenience store and may be cash intensive. The examiner should be alert to the existence of this type of activity in an existing business. A helpful technique is to document the flow of receipts from the rental of a tape to the tax return, and tracing the income flow. The examiner should include questions in the initial interview regarding exactly how the gross receipts were determined.

These tapes are purchased from wholesalers and are paid for generally by check and sometimes by cash. Watch out for illegal, bootlegged tapes/DVD. These may be paid for in cash and will usually only occur in the smaller video/DVD rental locations. As in all cases, the examiner should question any cash purchases over the threshold amount where no information reporting (Form 1099) was made to the supplier.

### **Cost of Goods Sold**

Many businesses may deduct the cost of video/DVDs as purchases in cost of goods sold. The taxpayers are not in the business of selling tapes. They are in the business of renting tapes; therefore, the tapes must be depreciated.

### **Expenses**

#### *Damaged or Lost DVDs*

The shelf life of a video/DVD varies depending on the frequency of use. After several months of renting the video/DVD in the store, some taxpayers rent the video/DVD to groceries and/or convenience stores. After extensive use of the video/DVD, they may be sold outright to customers. The customers may damage some video/DVDs after several uses. The taxpayers may claim the customers' video/DVD machines may be defective or the video/DVD may be left in a hot or cold car before returning it to the video/DVD store. Natural fatigue on the film stripe of the tape will also cause the tapes to be damaged. The business should be able to specifically identify tapes that were destroyed and have a record of the date and type of damage.

The business will also maintain a list of video/DVDs, which were rented but had not been returned to the store. There will be records for collection attempts and this could be used to determine allowable write-offs.

The taxpayers must prove that the tapes were sold or disposed of within the year before they would be allowed a current year write off. This may lead the examiner to unreported income from the sales of tapes.

#### *Depreciation*

Revenue Ruling 89-62 provides the proper methods of deducting the video/DVDs. It was held that "video/DVDs are subject to section 167 of the Code and may be depreciated in accordance with the straight line method over the useful life of the video/DVDs in the particular taxpayer's business. Alternatively, the income forecast method may be used." Section 168(f) (3) of the Code provides that section 168 does not apply to "any motion picture film or video/DVD tape.

The primary position to take is to allow the tapes to be depreciated in accordance with the straight line method, using a 3 or 5 year life, depending upon the taxpayer's business, with a half-year convention.

Revenue Ruling 89-62 allows the income-forecast method as an alternative. The taxpayers must maintain very detailed records to properly apply this method and is usually allowed only under those strict conditions.

Video/DVD retailers sometimes deduct the purchases of tapes as purchases and then also depreciate the tapes. In other words, they would double deduct the tape acquisitions, and in this case an adjustment will be made to disallow the purchase cost.

Be alert to convoluted bookkeeping. For instance, one example of this involved a taxpayer who deducted all of their tape acquisitions under purchases, depreciated the tapes and then indicated they backed out the deduction by listing all of the tapes purchased since they had been in business in ending inventory. The examiner was able to establish that the taxpayer's ending inventory was overstated due to tape sales to customers, gasoline stations and grocery stores.

In a Technical Advice Memorandum, IRS said that movie and TV films and tapes are intangible property for the purposes of section 179 deduction. Therefore, Section 179 deduction is not allowable.

## Glossary

**Bar Code** Information encoded into a pattern of varying-width parallel bars and spaces that can be read by a scanner/bar-code reader and interpreted as a numeric or alphanumeric identification code. Common symbologies used in retail are UPC-A for merchandise marking and Code 128 (also I 2 of 5) for shipping containers. Other symbologies used include: Code 39 and EAN. See 2-D Bar Code.

**Bar Code Density** The number of data characters per inch (or other measure).

**Bar Code Label** A label, generally both human- and machine-readable by an automatic scanning device. It is often used in shipping.

**Bar Code Reader** Device that reads bar codes; implies an optical device such as CCD rather than laser.

**Bar Code Scanner** Device that reads bar codes; implies a laser device.

**Cards** A record of a customer's account kept on cards for ease of handling and tracking. This is a small version of the posting of ledger cards usually filed by date instead of by customer name to facilitate renewals. When a computer system is in use, this copy may be listed by computer instead of on a card.

**Card Close** The total number of past-due customer accounts on a particular day usually expressed as the ratio of expired accounts to total.

**Card File** The files where all of the store's rental agreement cards are kept.

**Cash Drawer** The drawer where the cash and checks received from the day's business transactions is stored, until deposited in the bank.

**Cash Flow** The amount of money generated by a business less the cash expenses of doing business.

**DVD** Digital video disc player.

**Credit Authorization and EDC Utilities** Software integrated into a POS system to provide access to credit authorization, check authorization networks, and settlement banks.

**POS** Point-of-Sale. Can refer to the location in a retail store where consumer sales transactions occur, and to the sales data collected there. Also called scan data.

**POS Register** Incorporates products normally associated with POS systems (e.g., computer, printer, monitor,

keyboard, scanner, cash drawer, card reader, etc.).

**Promotional Product** A product subject to wide variations in sales because it is often sold with an incentive such as a price reduction. Often refers to products with difficult-to-forecast sales based on history.

**Renewal Card** The back of the last copy of the rental agreement used for payment information previously called Collection or Route Card.

**Renewal Date** The last day when a customer can make a renewal payment and keep the agreement in good standing.

**Renewal Ratio** The percentage of agreements renewed to total agreements at the end of each day and calculated in units, dollars or both.

**Returned Check** A check written by a customer for payment of a rental agreement that is refused by the bank for insufficient funds, closed account, etc.

**Returned Check Log** A listing of the returned checks to the business per day or per week.

**Shrinkage** Losses from theft and lost product. Refers to difference between actual inventory versus what the system says should be in a location.

**Unit Yield** The total dollars of actual rental revenue plus any special charges (delivery, reinstatement, etc.) divided by the number of units on rent.

**Units on Rent** The number of items on rent in a particular store at a particular time. Also known as Balance On Rent (B.O.R.).

**Valid Rental Agreement** A rental agreement in good standing between a rental company and a customer for merchandise rental.

**VCP** Acronym for a videocassette player. A machine that is designed for playback of videocassettes only and does not record.

**VCR** Acronym for videocassette recorder. A machine that can both record and play back programs.

**Vendor** A supply source that a business uses to acquire goods to rent.

**Vertical Rack** Audio system housed in a vertical cabinet.

**Video** Equipment for the reception, recording or playback of a television or videocassette picture.

## Statistics

Bizstats.com shows that almost 49% of sole proprietors in the video tape and disc rental business report a net profit.

## *Gasoline Service Stations*

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### **Introduction**

The service station has historically been the type of business where most of the income and many of the expenses are paid in cash. As such, the normal audit trail is more difficult to follow than other businesses with tighter internal controls. Sometimes no records are maintained or they are kept sporadically and in a disorganized manner. For these situations we have developed some alternative approaches to computing income for a service station under audit. In a state that has sales tax you can work through your Fed-State contacts to get gross sales information. For example, the California State Board of Equalization provides information for California service stations.

The initial interview is very important in such businesses. The following questions have been developed to assist you in evaluating a service station business:

### **Initial Interview Questions**

These questions were developed to provide enough information for the examiner to accurately estimate the income when a Survey is not available and/or the audit is limited primarily to the income issue.

1. What are your gasoline products' mark-ups per grade?
2. Was the mark-up the same in prior years?
3. What is your merchandise product mark-up?
4. Was the mark-up the same in prior years?
5. Do you have inventory on consignment (fuel, merchandise, etc.)?
6. What is your hourly rate for mechanics?
7. What is the daily gasoline sales volume? By type of gasoline? By season?
8. What is the daily merchandise sales volume? By season?
9. How often do you receive a fuel or merchandise load?
10. Do you accept credit card sales? What percentage is gasoline? Cash?
11. Name all the companies you get gasoline or other products from?
12. What was the beginning and ending inventory for the year(s) in question?
13. Has the station been remodeled? When? How long was the station closed for remodeling? Who paid for the remodel? Did the taxpayer receive any reimbursement for the remodel? Did he or she receive financial reimbursements such as business income replacement?
14. Name all of your suppliers of gasoline and other products you offer for sale.
15. What percentage of gasoline sales is full service?
16. Do you purchase blending products such as alcohol, naphtha, and transmix?
17. Do you own your delivery trucks? If yes, do you supply your own fuel? Who do you buy it from?
18. Do you distribute your product to anyone else?
19. Were you required to file a Form 720 (Excise Tax) or Form 2290 (Highway Use Tax)? Did you file it (them)?
20. Is all fuel purchased with Federal Excise Tax included? (Obtain copies of sample invoices for all fuel types.)
  - Be aware of taxpayer buying tax-free. If found contact your local excise tax agent.
21. Number of bulk storage tanks.
22. Capacity of bulk storage tanks.
23. Number of gallons in inventory at year-end.
24. Is gasoline ever sold as diesel fuel?
25. How do customers use propane?
26. Are other items sold or services rendered at the location(s)?
  - That is, unbranded pumps, car wash, snow plows, cigarettes, beverages, vending machines, tires, repair bays, licensing for state inspections, mini-mart, lottery tickets, etc.

- AAA and other towing companies - Stations often have their own trucks. They used AAA and other companies to tow in automobiles, for which the stations are subsequently paid by the towing company. Contact the auto club to determine their procedures for releasing this information.
27. Location and Sales — expect a good location site to have a high volume of sales.
  28. Sites that have a beer and wine license will sell much more merchandise than stores without the license.
  29. Are cars for sale at the location?
    - Motor Vehicle Records — determine local or state procedures for securing this information.
  30. Be alert to any other service station(s) owned in whole or in part as an individual, partner, and/or shareholder.
    - Real Estate Records — for real estate sales and purchases. Contact your Collection employees for the best source of this information.
  31. Check the current selling prices and note variances between prices of gasoline at the taxpayer's station and other stations in the area.
  32. How many pumps? What are the grades of product being sold and are there any other types of products such as diesel fuel, propane, or blending products?
  33. Have internal controls been addressed? Are the internal controls currently in place the same as during the year under audit?
    - **Note:** Los Angeles Counsel recommends that information about the area (good, bad, industrial, residential, etc.) be gathered for cases under their jurisdiction.
  34. TECS - (Treasury Enforcement Communication System) money declared with Customs when taken in or out of the country selectively
  35. State and Federal Agencies responsible for:
    - Sales Tax
    - Weights & Measurements
    - Environmental Concerns
    - Measurement Standards; etc.
  36. Bank Deposit Analysis
    - A bank deposit analysis may not work for all cash businesses. Many businesses that deal heavily in cash do not deposit all cash received.
    - Recently, more people are using debit cards and credit cards to pay for gasoline and diesel fuel purchases. Also service bay repairs are normally paid by check or credit card. Therefore, it is now easier to use a bank deposit analysis as an indirect method to support our BLS adjustment.
    - The key to doing a bank deposit analysis for a service station business is to remember to add to bank deposits the amount of credit card sales and cash payouts. When a person buys gasoline at a gasoline station by using an oil company (ies) credit card, the oil company (ies) receives the credit card sales money directly. The oil company (ies) then gives the service station owner credit for his or her daily credit card sales against the fuel purchases.

## Income

Service Stations are more than dispensers of gasoline. The typical station has 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 with or without Tow

- Towing
- Kerosene

#### *Site Visitations*

A visit to the station prior to the start of the audit will make the examiner's job a lot easier. Put a copy of the map showing the location of the station in the file. Compare the prices of the taxpayer's station to competitors nearby. Do they now or did they use to offer cash discounts? One very important thing to observe is how many customers are pumping their own gasoline and how many are getting full service. Also observe the types of non-gasoline activities.

#### *Summons the Oil Company*

If initial observations suggest that the taxpayer may be underreporting income, consider issuing a summons to the oil company (ies) for records for its sales to the service station. As added by the Taxpayer Bill of Rights, IRC section 7602(c) requires that we give taxpayers reasonable notice in advance of all contacts with third parties made regarding the determination or collection of their tax liabilities. That Section also requires that we provide the taxpayer with record of all such third-party contacts. A summons served on a third party is a third-party contact under IRC section 7602(c). The advance notice of the third-party contacts required by IRC section 7602(c) must be given in addition to the notice of a third-party summons required by IRC section 7609(a). Therefore, provide the taxpayer with a Letter 3164 before issuing a third-party summons and complete a Form 12175 for each summons issued.

Give notice of this third-party summons as required by IRC section 7609(a) to the taxpayer and all other persons identified in the summons. Contact the appropriate Counsel office if you have questions about third-party summonses.

#### *Compute purchases and sales and compare to tax return* *See IRM 4.10 and SBSE Memorandum 2003-70*

After opening the audit if the observations suggest that the taxpayer may be underreporting their income, do not forego the new summons requirements of TBOR II and IRC sections 7602 and 7609 along with the Acts 3415 and 3417.

Again any questions should be directed to your local Counsel office.

- Go through your Internet access for your Bureau of Labor Statistics survey of periodic index of retail gasoline prices, listed by type of gasoline or diesel fuel and the service station regional location.
- Print a copy of the portion of the BLS Survey that covers the area in which your area lies.
- Prepared spreadsheet to tailor spreadsheets for your area using the BLS Survey information received.

Spreadsheet should include the following items:

1. company name
2. type of gasoline sold (unleaded, and premium)
3. full or self-service
4. average price of gasoline per BLS Survey

When the summoned information comes in, run the Bureau of Labor Statistics Survey (BLS) analysis for determine gasoline and diesel fuel gross receipts. Calculate the gasoline gross receipts by multiplying the BLS price and the gasoline gallons purchased (per the summons) to compute the potential gross gasoline sales. Then compare this calculated amount to the amount on the tax return and determine whether an adjustment is indicated. Do not forget to consider non-gasoline sales when comparing your BLS computed gasoline and diesel fuel sales to the tax return.

Compare the dollars and gallons-purchased information received from the Oil Company (ies) to the tax return. Remember, this is only the gasoline/diesel fuel sales and there are probably other items being sold at the station. See below for other items.



A realistic approach to using any other survey is to consider its reliability as a gross sales analysis tool and its defensibility in court. Any reference to surveys should include the new statutory provision and examination restrictions. In the case of an individual taxpayer, IRC section 7491(b) places the burden of proof on the Service with respect to any item of income which was reconstructed solely through the use of statistical information (for example, BLS statistics is "solely" used to reconstruct Income). Further such "sole" use of statistics is contrary to Service guidance which limits its usage to non-filing and uncooperative taxpayers.

While we believe that a proper examination as described in this ATG would not run afoul of IRC section 7491(b) and that these surveys can continue to be used to determine income. We *emphasize again* that they may *only be used* in conjunction with other information, which would support a conclusion of unreported income.

### **Surveys**

Surveys can be used but we must first show that either the books and records are unavailable or that they are inadequate to determine the substantially correct tax.

#### *Bureau of Labor Statistics (BLS)*

This is a Government Indexes and Databases survey covering approximately 82 markets throughout the United States. It does not compile data by Oil Company (ies) 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.*

While BLS statistics can be used to support an income adjustment, such statistics may *not* be used *solely* to determine income. IRC section 7491(b).

#### [American Automobile Association \(AAA\)](#)

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. Provides in its AAA Daily Fuel Gauge Report, comprehensive retail gasoline surveys, based on daily data taking in over 60,000 self-serve stations.

#### *U.S. Department of Energy*

Currently each state is required, under the old Windfall Profit Act, to survey its area for prices. Some states use outside surveys such as AAA. Others do their own survey. Although limited to the area surveyed, this may be a useful method to discover your taxpayer's area pricing.

#### *Lundberg Survey*

The Lundberg Survey provides retail-selling prices for gasoline and diesel fuel. The prices are listed by: type of Oil Company, full service, self-service, credit, cash, 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).*

#### *U.S. Department of Commerce*

Economics and Statistics Administration, [Bureau of the Census](#), provides a periodical Census of the Retail Trade, including Gasoline Retail Stations.

#### *Food Wholesalers*

Suppliers can be located through your local telephone directory. Cigarette distributors also can be located through the local food wholesalers. These suppliers usually supply invoices with not only purchases but with suggested sale prices.

Look for the total sales of these products. Then find out where purchases were made and how they were made (cash, credit, etc.).

#### *Auto Body Repairs*

A unique method recently found is the use of the state smog certificate/inspection information available through the

state. In California this would be the California Bureau of Automotive Repairs. This information not only gives us the actual smog certificates issued BUT also the repairs made to bring the car to certification level.

Notice that when comparing the records presented to the examiner during the audit and the records presented from the State the information should match. If not, there is underreporting.

*Sale of Business Assets or Franchise*

Sales of service stations go through escrow and are recorded in document repositories such as the county court houses (for example, in Los Angeles at the Hall of Records).

Frequently, the taxpayer(s) has sold either the gasoline station or other properties and the capital gain has not been reported. Watch out for this. Real estate records are helpful with real property.

The oil company (ies) has agreements that allow new owners to purchase the assets of the business and pay off the liability by being charged an extra few cents a gallon for purchases.

Since this should not be charged to cost of goods sold, but rather should be charged against a payable, agents should obtain copies of the purchase agreement and discuss this at the opening conference. The extra charge is a combination of interest and principal and must be distinguished.

Agents should consider the impact of the sale of franchise rights and franchise agreements/lease versus sales.

*Missing Stations*

There have been cases where taxpayers file a tax return, including a Schedule C, but omit one or more of their other gasoline stations. When serving the summons, request "this station and any other stations, owned or operated by (the taxpayer)." Watch for statements showing deliveries to different addresses and other clues that the taxpayer owned more than one station.

Provide both the Social Security Number and Employer Identification Number on the summons to assist the oil companies in this search.

**Note:** A significant variance between monthly purchase volumes could indicate the sale or purchase of a station or multiple suppliers.

*Mechanic/Service Bays*

Bay services income sources consist of an hourly rate and parts charges. Although each Area has a different hourly rate, the rate is usually posted at the business and the consumer is notified of it before the repair is authorized. Anyone going to their local mechanic will see the amount. The charges for parts also vary depending on Area.

In order to illustrate a very simple example of this source of income, we will work with only one bay and one mechanic. In this example, the hourly rate charged is \$40 for 6 hours work for a total of \$240 in income.

Daily income	\$240
Per person wage of \$20 for 8 hours	160
Profit per day	<u>\$ 80</u>

At \$80 per day and 315 days worked, the total amount of gross profit is: **\$25,200**

**Note:** This does not include parts, where there is normally a 50 percent or better mark-up. This \$25,200 could double if the average part sold was, for example, \$240, and the cost was \$160. The service bay profit would be \$50,400. Also, note this is for one bay; usually there is more than one bay per station.

#### *Service Parts Suppliers*

The typical service repair station purchases parts on a cash basis. Following this trail is very difficult but not impossible. First, review the overall income per service bay. The mechanic bay example above would have over \$750,000 per service bay in just the hourly rate. The mechanic is usually an employee.

Review the repair invoices, which should be sequentially numbered and reasonable in amount. For example, there should be a labor charge, not just a charge for parts. Also consider what to do about missing invoices. Look for the voided, and estimates of, service bay repair invoices. The examiners should be able to interpolate from these available invoices the total service bay repair income.

Remember, if a station owner shows you a repair bay operating at grossly less than the wages of its mechanic, there is further reason to investigate.

## **Expenses**

#### *Rent/Other Expenses*

Another situation, which appears in a number of cases, is the double deducting of the expenses. For example, many oil companies bill the taxpayer through the purchase invoices, for items such as rent. The taxpayer takes the full amount of the purchase invoice as a purchase deduction and also takes the rent (again) as an "other expense" of the total ordinary business expenses. Check for this on rent statements or purchases statements. The agreement between the dealership and Oil Company (ies) is also a good source of information.

Another problem with rent occurs when the taxpayer takes the full amount shown for rent per the purchase invoices. However, most of the major oil companies charge rent based on gallons purchased, but then the oil company (ies) gives the taxpayer a rent rebate.

#### *Franchise Fees and Covenants Not to Compete*

This could be disguised goodwill. Goodwill is an intangible asset as defined in IRC section 197. For pre-August 11, 1993, acquisitions, goodwill (for example; acquired in connection with a franchise) cannot be written off, but remains on the books as a capitalized item. For purchases of a franchise entered into after August 10, 1993, the taxpayer must amortize the intangible asset (even if part of the intangible is disguised goodwill) over 15 years using the straight-line depreciation method. IRC section 197 was added in the Revenue Reconciliation Act of 1993 and permits 15 years straight-line depreciation for IRC section 197 intangibles, which specifically include franchise fees, covenants not to compete and goodwill. A taxpayer may elect to apply the provisions of IRC section 197 retroactively to property acquired after July 25, 1991. Don't forget to consider the whipsaw issue between what the taxpayer claims as an expense and what the seller claims as a capital gain.

#### *Prepayment Account*

Sometimes the taxpayer has a 1- or 2-cent additional per-gallon charge on the invoice. This money is placed in somewhat of a savings account. It is the taxpayer's money and he or she earns interest on the deposits (check Form 1040, Schedule B). Check to ensure that the taxpayer has not claimed this as a cost of goods expense. The reserve account is included on the gasoline purchase invoices. Make sure that if you see gasoline reserve on a purchase invoice that the bottom amount of the purchase invoice does not include the prepayment amount. Additionally, ensure that the taxpayer has included as income any interest credited to this account for benefit of the taxpayers.

#### *Rebates*

Major oil companies give rebates for increased purchases. These are incentive programs. Generally, rebates are required to be offset against the purchase price of the merchandise on which rebates are computed. The most common one used is for a new owner of a station or an owner who has remodeled his or her station. This is

frequently 2 to 5 cents per gallon, applied to the volume increase and can total up to \$100,000 per station, per year. The oil company (ies) will generally apply this to the station rent or as a credit to the taxpayer's account.

Check to insure that the taxpayer does not *deduct* the full amount of the purchase through cost of goods sold without reducing it by the rebates. See Treas. Reg. section 1.471-3(b). Lately, the major oil companies will pay a rebate for the stations to be shut down for remodeling or replacement of the under ground storage tanks. Some oil companies give rebate incentives for stations being open 24 hours.

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 sections 446 and 481 apply. See Rev. Proc. 97-27, 1997-1 C.B. 680.

#### *Other Taxes*

Watch out for amounts equal to taxes (sales and excise) collected by the oil companies but not shown in the purchase documents summoned. It is important to determine whether these amounts were included in the total dollars and per-gallon figures of the summoned documents. (Very important: The retail-selling price in the BLS Survey includes all appropriate taxes. Make sure that any prepaid taxes are included in the purchases.) It is a common practice for the gasoline station (and their suppliers) to collect the amount of sales tax or excise taxes from the consumer. Watch out for double deductions, that is, taxes to be included in the cost of goods sold as well as a separate expense item.

The federal taxes on gasoline, diesel fuel, and, beginning July 1, 1998, kerosene, are imposed on the products before the products are delivered to the service station. Thus, the Retailers are not responsible for paying these taxes to the government; rather, the amount of the taxes is usually included in the station's purchase price of the products. This is common in many states. However, see the discussion of "Blending," below. The operator generally is liable for the tax on propane and other liquefied petroleum gasoline (LPG) that it sells for use in vehicles.

#### *Netting Taxes*

The oil companies collect the pre-collected sales tax. The taxpayer receives credit for this pre-collected sales tax on their state sales tax returns. One common problem found during audits is where the taxpayer deducts the full amount of the gasoline and diesel fuel purchase invoiced as purchases per return. However, many taxpayers report their gross receipts net of sales taxes. Therefore, if a taxpayer reports their gross receipts net of sales taxes, then make sure their purchases are reported net of the pre-collected sales tax.

#### *Dyed Fuel*

Diesel fuels and kerosene that has been dyed red according to Treasury Regulations has not been taxed when the fuel is delivered to the service station. 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 must be posted by the seller on any retail pump where it sells dyed diesel fuel or dyed kerosene for use by its buyer. A substantial penalty (and tax) may be imposed on a person that sells dyed fuel for a taxable purpose, such as for use in a registered highway vehicle. If you suspect that these rules are being violated, contact your excise tax group immediately.

#### *Blending*

Some service stations sell gasoline and diesel fuel into which the operator has added previously untaxed liquid. 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, waste oil, and (before July 1, 1998) kerosene. Generally, the blender owes excise tax on this increased volume of fuel. If you suspect that a blender is not paying the tax to the government, contact your excise tax group immediately. If you find an invoice for one of these blending products, serve a summons for all purchases and add this to the original gasoline or diesel fuel purchases before applying the BLS pricing. Note that the taxes (both excise and sales) could be over 40 cents per gallon.

**Examples of "Blending-Product Switching" Recipes for Higher Profits**

*Example 1*

In this example, 2,000 gallons of regular unleaded gasoline are sold as premium unleaded gasoline.

<i>Product Purchases</i>		<i>Product Sales</i>	
Product .....	Gallons	Product .....	Gallons
Reg. Unlead	5,000	Reg. Unleaded	3,000
Prem. Unleaded	1,000	Prem. Unleaded	3,000
Gals. Taxed & Purchases	-----	Gals. Taxed & Purchases	-----
	6,000		6,000

*Example 2*

In this example, 5,000 gallons of regular unleaded gasoline become 5,000 gallons of premium.

<i>Product Purchases</i>		<i>Product Sales</i>	
Product .....	Gallons	Product .....	Gallons
Reg. Unleaded	5,000	Reg. Unleaded	-0-
Prem. Unleaded	-0-	Prem. Unleaded	5,000
Gals. Taxed & Purchases	-----	Gals Taxed & Purchases	-----
	5,000		5,000

*Example 3*

In this example, 6,000 gallons of regular unleaded were mixed with 1,000 gallons of previously untaxed naphtha and premium unleaded. It is sold as premium unleaded. The amount of the tax from the sale is collected but not reported.

<i>Product Purchases</i>		<i>Product Sales</i>	
Product .....	Gallons	Product .....	Gallons
Reg. Unleaded	6,000	Reg. Unleaded	* 4,000
Prem. Unleaded	1,000	Prem. Unleaded	* 4,000
Naphtha	1,000		-----
	-----	Gals. Taxed on Sale	8,000
Gals. Purchased	8,000		
	*Gals. Tax Paid On 7,000		

*Example 4*

In this example, 6,000 gallons of diesel fuel is mixed with 1,500 gallons of previously untaxed transmix and sold as diesel fuel. The amount of the tax from the sale is collected but not reported.

<i>Product Purchases</i>		<i>Product Sales</i>	
Product .....	Gallons	Product .....	Gallons
Diesel fuel	6,000	Diesel fuel	* 7,500
Transmix	1,500		-----
	-----	Gals. Taxed on Sale	7,500
Gals. Purchased	7,500		
	*Gals. Taxes Paid On 6,000		

*Imaging Reimbursement*

Oil Company (ies) sometimes makes cash or property payments to a gasoline station owner for the purpose of improving the image of the owner's station - thus the name "imaging reimbursement payments". The station owner maintains title to the improvements. Improvement of the station may be contingent upon the station owner purchasing a specified volume of petroleum products.

Monies are given to the station owner to be 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.

Issues arise because:

- The cash is usually called a no-interest loan and there is no expectation of repayment.
- Sometimes the contract reads that there is expectation of repayment but provisions are so vague that anyone can meet them and no repayment is made.
- Payments usually exceed costs involved and the taxpayer may capitalize the improvements even though he is not the true owner of the property.
- Or, the taxpayer may deduct the expenses and not report the income.

#### *Types of Reimbursements*

The oil company (ies) may disburse the cash payments in a lump sum or in a series of payments upon the purchase of petroleum products. The oil company (ies) might also require the station owner to pay for the improvements before disbursing the cash payments.

#### *How Should It Be Reported?*

The facts and circumstances of your specific image upgrade program may vary from the typical program 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 (ies). We recommend that a gasoline station owner consult with a tax advisor to determine the proper tax treatment.

#### *Typical Treatment by Recipient*

- Cash Payments

Generally, a gasoline station owner should include the cash payment fully in gross income in the taxable year that is proper under the station owner's method of accounting.

In an overwhelming majority of cases, station owners must use an accrual method of accounting. If the purchase, production or sale of merchandise is an income-producing factor in the taxpayer's business, then the taxpayer generally must maintain inventories. But see Rev. Proc. 2001-10, 2001-2 I.R.B. 272, 2001-1 C.B. 272 (Jan. 8, 2001). (Providing a "small taxpayer exception" from the requirements to use an accrual method under IRC section 446 and to account for inventories under IRC section 471 for taxpayers with average annual gross receipts of \$1,000,000 or less.)

Taxpayers who maintain inventories are required to use an accrual method of accounting unless the Commissioner authorizes the taxpayer to continue to use its present method of accounting. The courts have developed a test to determine whether the Commissioner has abused his discretion in not permitting a taxpayer to continue to use its present method. That test is the substantial identity of results test (SIRT). If a taxpayer meets the SIRT then it will be permitted to continue to use its present method.

Under the SIRT, the taxpayer must establish that its present (generally cash) method of accounting produces substantially identical results to the accrual method proposed by the Service. The courts have held that where the difference is as little as 1.32 percent or 1.6 percent the methods do not produce substantially identical results. *Wilkinson-Beane v. Commissioner*, 420 F.2d 352 (1st Cir, 1970); *Surtronics, Inc. v. Commissioner*, T.C. Memo 1985-277.

- Expenditures

A gasoline station owner may deduct certain costs paid with monies received under an Image Upgrade 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 cost may include incidental repairs and advertising.

A gasoline station owner is not permitted to 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. These costs must be treated as capital expenditures. For example, expenditures for new signage and new gasoline pump. Generally, such costs may be recovered through depreciation or amortization. Any remaining basis is taken into account in determining gain or loss when the property is sold or otherwise disposed of.

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 sections 446 and 481 apply.

- Other compliance issues:
  1. The money received may not be used for business purposes.
  2. The taxpayer may treat the payment as a loan, and then capitalize the improvements.
  3. The taxpayer deducts the expenses and does not report the income, or
  4. Attempts to defer the inclusion of income over time.

#### *Questions to Answer*

Several questions arise in deciding whether or not an amount received should be considered a loan or income to the recipient:

1. Was there a debtor-creditor relationship created at the time the proceeds in question were received by a party to the transaction?
2. Was there intent to repay the other party?
3. Did the creditor intend to enforce the "obligation"?
4. Was the transfer documented and evidenced by written agreements? (For example, is there a note?)
5. Was interest paid?
6. Was there regular repayment of principal or interest by the debtor?
7. Was there a specific date for repayment of a sum certain by the debtor? Alternatively, was the repayment predictable and realistic?

Most loans usually have a date certain for repayment and a defined periodic payment amount (for example, bank home loans). In some situations there may not be a definite periodic payment amount being repaid, such as payment per gallons purchased. It is not necessary to have a definite fixed monthly amount to have a valid loan as long as the taxpayer's loan meets the court's definition of a bona fide loan (as discussed below).

#### *What is a Loan?*

The Tax Court considered certain objective facts to determine the taxpayer's intent and whether a bona fide loan occurred. The factors derived from case law and applied by the Tax Court included:

1. The existence or non-existence of a debt instrument;
2. Provisions for security; interest payments and fixed payment date;
3. Whether or not repayments of a loan were made;
4. 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 *Colombo v. Commissioner*, T.C. Memo 1975-162.

#### *Incentive Agreements*

These agreements go by many names. Some of these have been noted above, such as imaging or rebates. Incentive "awards" or agreements may be paid in many fashions, usually as a discount of certain cents per gallon or a

discount for purchases over a certain monthly volume. This money may also be given to the taxpayer as a lump sum. Some large oil companies pay this on total yearly sales. Notice that this could be quite a sum of money if the taxpayer sells millions of gallons of product. Competitive allowance, paybacks, advertising allowance or subsidies, and profit participation are just a few names given to these agreements.

#### *Accommodations*

Payments between the major oil companies and service station dealers may involve the refund to dealers of gasoline purchase charges in excess of the customary charge for gasoline. The excess charge is retained in a separate account to be used for the discretionary benefit of the dealer. This could be called a number of things, such as liquidation/accommodation agreement, or security agreement.

Disbursement of the funds could go directly to the dealer or payments are made on behalf of the dealer to a third party.

This type of agreement allows the dealer to take the full amount of the invoice when only the actual business expense should be deducted. Disallow the accommodation amount included in the purchases. This will decrease cost of goods sold and increase gross profit.

#### *Shrinkage, Leakage, Theft, and Personal Use*

Although the taxpayer may claim these as reasons for substantial loss of gallonage or a discrepancy in the cost of goods sold, experience has shown that this amount should be de minimus. Any large amount claimed should be substantiated. For example if there has been substantial leakage, the local environmental agencies or fire department would have been involved in the cleanup.

#### *Tank Replacements*

This is a depreciation expense to the OWNER of the property. Generally, the major oil company (ies) owns the property. Lately, the major oil companies will pay a rebate for the stations to be shut down for remodeling or replacement of the underground storage tanks. Revenue rulings that reflect particular allowances for depreciation for owners:

*Depreciation, Revenue Ruling 98-25, 1998-19 I.R.B. 4, 1998-1 C.B. 998*

*Environmental Cleanup, Revenue Ruling 94-38, 1994-25 I.R.B. 4, 1994-1 C.B. 35*

*Environmental Cleanup, Revenue Ruling 2000-78, 2000-9 I.R.B. 712, 2000-1 C.B. 712*

Moreover, IRC section 168(e) (3) (E) specifically includes as 15-year property “any IRC section 1250 property which is a retail motor fuels outlet (whether or not food or other convenience items are sold at the outlet).”

For purposes of applying these class demarcations to service station building and canopies, IRC section 1245 property is personal property, while immovable property or land improvement have to be considered IRC section 1250 property.

Thus, the qualification for the shorter 5-year life depends on whether the particular asset can qualify as personal property. If so, the asset may be depreciated over 5-years (in Class 57.0 the asset has a class life of 9 years which, under IRC section 168(e), renders it 5-year property). Note that this could apply not only to canopies but also to modular service station buildings. Conversely, if the asset cannot be considered personal property but must be considered a building, a structural component of a building, or land improvement, in other words something which would be considered immovable property, the asset falls into Class 57.1 with a Class life of 20 years, rendering it 15 year property under IRC section 168(e).

#### *Gasoline Retail Station Building vs. Other Nonresidential Building (5 years, 15 years, 39 years)*

1. *Modular Structures*

If the Service Station building is a modular structure and would have to be considered movable personal



property, it would fall into Class 57.0 with a 5-year depreciation period. Typically, only smaller modular structures (for example, kiosks) will qualify. In Rev. Rul. 75-18, 1975-1 C.B. 9, abandoned the functional use test. Thus, the mere fact that a modular structure is used like a building does not require its characterization as a building. The critical indicia are, as later highlighted in *Whiteco Indus., Inc. v. Commissioner*, 65 T.C. 664 (1975), whether the permanence of the structure is evident from the installation and the design. *Fox Photo Inc. v. CIR*, TC Memo 1990-348, emphasized again the criteria of whether the structure is easily movable and whether constructed in a manner that reflects anticipation of the structure having to be moved. The absence of a plan to move a modular structure is not critical, that is, indefinite installation does not taint the personal property characterization.

## 2. *Fixed Station Buildings*

If there are significant sales other than traditional gasoline station products (motor fuel, lubricants, tires, batteries, other auto accessories, soft drinks and cigarettes), that is, in the case of a convenience store that is combined with gasoline sales, test the facility to determine whether it is used primarily in petroleum marketing. For Service Station Buildings (other than modular buildings, which would qualify as personal property), the Coordinated Issue Paper of April 2, 1997, provides further guidance. It discusses IRC section 168(e) (3) (E) as added by section 1120 of the Small Business Job Protection Act of 1996 (the Act). This section now provides that the term "15-year property" includes

“any section 1250 property which is a **retail motor fuels outlet (whether or not food or other convenience items are sold at the outlet).**”

The legislative history (S.Rep. No. 281, 104th Cong., 2nd Sess. 15 (1996)) envisions for a gasoline retail outlet that at least 50 percent or more of the

1. gross revenues are generated by traditional gasoline station retail, or
2. floor space in the building (including restrooms, counters, and other areas allocable to traditional service station "services") are devoted to the petroleum marketing activity.

"Gross revenue" is defined as the revenue generated by the sale of the product to the consumer. For purposes of determining whether a C-store building qualifies as a retail motor fuels outlet, gross revenue *includes* all excise and sales taxes.

The gross revenue attributable to petroleum sales (motor fuel, lube oil, battery, tires, auto accessories and other traditional motor fuel retail outlet sales) should be compared to gross revenue from all other sources (for example, food items, beverages, lottery, video rentals, etc.). If the petroleum sales as reflected in (a) receipts or (b) floor space utilization, are greater than the non-petroleum sales receipts or floor use, the building qualifies as 15-year property. The gross revenue should be analyzed for a full tax period.

Temporary fluctuations in the results of the revenue analysis should not be used to determine whether the building qualifies or fails the gross revenue test. For example, if a special promotion is run for a 6-month period and the gross revenue ratio is temporarily affected, the primary use of the building should not be changed. If the building initially meets (or fails to meet) the disjunctive 50-percent test, but subsequently fails to meet (or meets) such test for more than a temporary period, such failure or qualification is a change in the use of the property.

If either the petroleum sales or floor space use tests is satisfied, the building is treated as 15-year property; otherwise, the building should be treated as an ordinary retail building and, as a nonresidential real property has a 39 year life (31.5 years for buildings placed in service May 13, 1993). However, small structures of 1400 square feet used in the context of gasoline retailing need not to be tested and should be accepted as qualifying under IRC section 168(e)(3)(E) as gasoline retail outlets. See Sec. 2, Rev. Proc. 97-10, 1997-1 C.B. 628.

Change in classification is change in accounting method – gasoline stations

IRC section 168(e) (3) (E) is effective for structures placed in service after August 19, 1996. Taxpayers may elect to apply the provision to property that was placed in service before August 20, 1996. According to the legislative history, if a taxpayer has already treated the property as 15-year property the taxpayer is deemed to have made the

election. If a taxpayer has not treated the property as 15-year property the Service treats the election as an accounting method change, with automatic consent granted as provided in Rev. Proc. 97-10, 1997-1 CB 628, *supra*.

#### *Car-wash buildings, associated land improvements*

Car Wash Buildings are enumerated in Asset Class 57.1 property with 15-year depreciation, as are associated land improvements, such as pump islands.

#### *Canopies, Gasoline Brand Signs*

Canopies are in Class 57.1 with a 15-year life, unless they qualify under the *Whiteco* test; see above as personal property for Asset Class 57.0 and 5-year depreciation. In *JFM, Inc. v. CIR*, T.C. Memo 1994-239, the court held canopies to be personal property in Class 57.0, with a 5-year life. The canopies in that case were bolted down onto four to six special concrete footings. Of the 14 canopies at issue, the taxpayer had sold 2 to third parties for reuse, and at least 3 had been taken down and either moved to another location or had been rebuilt and reinstalled at the same location. Thus, some of these canopies had in fact been moved.

#### *The tanks, pipelines, and pumps*

Underground storage tanks, fuel dispensing pumps, and other automobile service equipment are under the *Whiteco* test typically considered personal property and to be subsumed to Class 57.0 with a 5-year life.

#### *Environmental clean-up issue*

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 section 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 section 263 and the regulations thereunder). These costs are nondeductible capital expenditures under IRC section 263.

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 section 263 are controlling.

A change to require the taxpayer to begin capitalizing costs required to be capitalized, which the taxpayer has currently deducted, is a change to the taxpayer's method of accounting to which the provisions of IRC sections 446 and 481 apply.

Moreover, neither IRC section 162 nor section 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.

## Web Sites

There are numerous State web sites. Please consult the following national web sites for their individual state association sites:

- [Society of Independent Gasoline Marketers of America](#) (SIGMA)
- [The Petroleum Marketers Association of America](#) (PMAA)

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## Glossary

**A G O** (*Atmospheric Gasoline Oil*) a volatile distillate.

**Back-Up Tax** 24.4 cents per gallon tax is imposed on dyed diesel fuel that is sold or used for other than a nontaxable purpose. (In addition to penalty)

**Cetane Number** a measure of the ability of a fuel to ignite spontaneously, desirable in the operation of a diesel fuel engine.

**Cloud Point and Count Point** describe the flow characteristics of fuel oil at low temperatures. These points are the temperatures at which wax crystals form and clog the fuel-injection system of a diesel fuel engine.

**Distillate** a refined petroleum product produced by the distillation of crude oil.

**Dyed Diesel Fuel** regulations specify dye concentration. Notice of dyeing is required on paperwork by terminal operators, distributors, and on retail pumps where dyed diesel fuel is sold. A penalty of the greater of \$1000 or \$10 per gallon is imposed for selling or using dyed diesel fuel for a taxable use or for altering dyed diesel fuel.

**Excise Tax Agent** audits excise tax returns (Forms 720 and 2290) and imposes back-up tax. All potential excise tax issues should be referred to the Excise Tax Group.

**Form 637** diesel fuel producers, refiners, importers, terminal operators, blenders, through putters, compounders and others, such as those selling or buying taxable items tax-free, are registered on Form 637.

**Form 720** used to report and pay the excise taxes listed on the form. A return should be filed for each quarter.

**Form 2290** used to compute and pay the tax due on heavy vehicles used on public highways. 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 (7500 miles or less for agricultural vehicles). Proof of payment of this tax is required to register your vehicle in any state.

**#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.

**#1 Fuel Oil** a light distillate used in vaporizing-type burners.

**#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.

**#2 Fuel Oil** a distillate used in atomizing type burners for home and other moderate size heating applications.

**#4 Diesel Fuel** used in low speed diesel fuel engines.

**#4 Fuel Oil** a blend of distillate and residual fuel oil used for commercial burners in larger size heating applications, such as industrial plants.

**Kerosene** similar to #1 fuel oil with specifications that improve it for use in space heaters, cook stoves and lamps.

**M D O (Marine Diesel fuel Oil)** a volatile distillate used specifically for marine/ship purposes.

**Naptha/Alcohol** used to mix with diesel fuel and gasoline. Naptha has no real purpose outside of blending with other products. While, alcohol can be legally blended up to 10% and sold as gasoline.

**Non-TaxableUses** 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.

**Rack** a mechanism for delivering fuel from a refinery or terminal into a truck, trailer, railroad car, or other means of non-bulk transfer.

**Residual Fuel Oil** a heavy oil that remains after distillation which is used for electric power generation, space heating, ship bunkering and various industrial application. Includes #5 and #6 fuel oils.

**Taxable Event** removal from terminal rack, entry into the United States, or removal or sale of blended diesel fuel.

**Transmix** the portion of products mixed in transport, that is, diesel fuel is mixed with gasoline while in transit.

**Ultimate Vendor** seller of undyed diesel fuel to the user of the fuel (purchaser) for use on a farm for farming purposes or for the exclusive use of state or local government. Registration (Form 637) is required in order to qualify for refund or credit.

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## Statistics

- [Bureau of Labor Statistics](#)
- [American Automobile Association](#)
- [U.S. Census Bureau](#)

# *Independent Automobile Dealerships*

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## **Introduction**

The used car industry is composed of two major segments. The first segment is made up of the new car dealers who accept trade-ins on the sale of new automobiles and can also purchase used vehicles directly from customers, other car dealers, or at wholesale auto auctions. The new car dealers then sell the used vehicles either to retail customers, to used car dealers, directly to wholesalers through auctions, or to other miscellaneous customers.

The second segment of the industry is made up of independent auto dealers. These dealers are not affiliated with an automaker and, their principal business is the sale of used vehicles. Since no trade franchise (that is, General Motors, Ford, etc.) is necessary, the size of the used car dealership and the capital required to enter the industry varies. However, every used car dealer must be licensed with the state in which the dealership is physically located.

Most states have different laws that govern the ability of individuals or businesses to sell used vehicles without a license. For example, one state permits an individual to sell up to five vehicles per year without obtaining a license. Other states are more or less restrictive. Independent auto dealers acquire vehicles from trade-ins on the sale of used vehicles. Such dealers also purchase vehicles from individuals (private purchase arrangements), other new and used vehicle dealers, and at wholesale or retail auctions.

Impact of state regulation and state law

Every state regulates the operations of the independent dealer and requirements vary from state to state. The specific requirements imposed on a dealer depend on the particular state in which the dealer does business.

Common dealership activities regulated by states include:

Transfers, assignments, and reassignments of titles

Title transfer processes

Collection and repossession rights and liabilities

Consignment rules and procedures

Payments of commissions for referring buyers

Additional information on state laws may be obtained from your state Motor Vehicle Division.

## **Curbstoners**

One problem that the industry faces is competition from unlicensed dealers (curbstoners) who buy, sell, and trade more used vehicles than a state allows without a license. In almost every case, the curbstoner has no fixed place of business and fails to adhere to most of the accepted industry practices or customs. It is not known how much revenue the curbstoners generate, although industry officials acknowledge that the amount is significant. Since curbstoners do business illegally it is likely that their income from sales goes unreported.

State attempts to enforce licensing laws against curbstoners are hampered by a lack of personnel and money. Furthermore, with no fixed place of business, a curbstoner is often difficult to track. Signs of potential curbstoning include:

Multiple auto listings in a paper with the same phone number

Displays of multiple vehicles "for sale" in shopping centers or similar parking lots all with the same phone number

### **Records**

The Federal Truth in Mileage Act requires odometer statements to be retained by both the buying and selling dealers. Most states require that a licensed dealer maintain certain records, which must be available for inspection by the appropriate state licensing or regulatory agency. Information about the records a dealer is required to maintain in a particular state can be obtained from the state agency responsible for the regulation of independent dealers. (Normally this will be the state Motor Vehicle Division or the state Department of Revenue.) Aside from these state and federal requirements, other specific records that must be maintained will vary from state to state.

The sophistication of the accounting and records system (including record retention) will normally vary with the dealer's size and location. However, there are certain common industry practices that provide documentation for a sales transaction. These practices will vary from state to state, since each state has different record retention requirements, but the basics will be the same. These industry practices are discussed in the various sections on income recognition and inventory. Currently, there is no overall computer accounting program specifically designed for independent dealers, however, there are many programs that are used by dealers.

### **Car Jacket**

The key record of a car sale is the car jacket, customer file, or deal jacket. A separate file is normally maintained for each sale. Many dealers create a deal jacket whenever a vehicle is purchased and assign a stock number to the vehicle. In that case, the deal jacket may also be used to track the cost of the vehicle and the cost of reconditioning the vehicle for sale. The file generally contains:

#### Cash Sale (No Trade-in)

1. Sales, Retail Buyer's order (including the VIN),
2. Buyer's name, address and other information,
3. Sales Price,
4. Sales tax (depending on the state, sales tax may be on the gross sales price or net sales price),
5. Documentary and Filing (Doc) fees,
6. State and Federal Disclosure statements, including Odometer readings,
7. Vehicle stock number,
8. Extended warranty or service contract information and information on any insurance purchased,
9. Form 8300, if applicable.

#### Sales with Trade-ins

1. Same items as for a cash sale, and
2. Payoff on any outstanding loans, if applicable,
3. ACV of trade-in.

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. A dealer will normally also 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 - Commissions from bank financing
- Customer paid service work

### **Auctions**

Aside from customer trade-ins, the most significant source of inventory for dealers is an auction. Dealers use auctions both to buy and sell vehicles. Dealers use wholesale auctions, where only dealers are permitted to buy or sell. Most dealer transactions are handled by the wholesale auctions. Some states also permit retail auctions, which are open to the general public, and may be used by the dealers as well.

Each auction company is run independently, maintains different records, and has its own procedures. Some common rules and procedures used in the auction industry include:

- Every dealer must register with the auction,
- The dealer will provide the auction with the year, make, VIN, and equipment of each vehicle offered for sale, either by phone or on site,
- The auction will issue the selling dealer an auction check, thereby assuming the risk of collection on the buyer's check,
- The auction will handle the actual assignment of title to the buyer.
- The seller may set the floor or lowest price that the vehicle may be sold for by the auction.

Generally, each auction holds its general wholesale sale once a week. It is common for dealers to attend more than one auction a week since each auction offers different types of vehicles in varying price ranges for sale. Special manufacturer and fleet auctions are held at various times throughout the year.

Dealers often attend several auctions a month, many of which are in another state. By attending auctions outside of his or her area, a dealer is able to take advantage of better market conditions for a specific type of vehicle. For example, a dealer in Florida may want to purchase convertibles, which may have a high price in the Florida market. However, a Wisconsin auction may offer convertibles for sale at much lower prices due to the lack of demand there. The Florida dealer will travel to Wisconsin, buy the convertibles, and profit from their sale to customers in Florida. Thus a dealer from one part of the country can benefit from obtaining vehicles at an auction in another part of the country.

While the overwhelming number of dealers may have a valid business reason for attending out-of-state auctions, such practices are also a compliance concern. A few dealers have been found attending out of state auctions to facilitate buying and selling vehicles "off the books."

The starting point of an auction is the registration of the dealers participating in the auction whether they are buying or selling. The auction generally requires that the dealer be registered in advance. This usually involves obtaining a copy of the dealer's license.

Once registered a dealer may participate in an auction. The selling dealer will provide the auction with the appropriate information about the vehicles offered for sale, as discussed previously. The vehicles will be assigned a number, which will be displayed on the windshield, and offered for sale. Since the seller has the right to set a floor price below which the vehicle may not be sold, not all vehicles offered for sale at an auction are sold. However, on average roughly 50 percent of the vehicles in a regular wholesale auction will be sold.

Once a buyer has successfully bid on a vehicle at auction, he or she is afforded an opportunity to inspect the vehicle to be sure that all representations about the vehicle made by the seller are correct. If there are no problems, the buyer then proceeds to settlement, and gives the auction his or her check for the purchase price. The auction fills in the title in the buyer's name and delivers the title to the buyer.

On the other side of the transaction, the seller will sign the title and deliver it to the auction for completion. The seller will then receive an auction check, with the restrictions noted below. Each party will also receive an invoice (Block Ticket) that shows the vehicle sold, as well as the identities of the seller and buyer. The auction invoice will also usually include an executed odometer statement.

The auction will not usually issue payment to a dealer without proof that a business bank account exists. Additionally, the auction normally provides restrictive endorsements on the check issued to the dealer to be certain that the proceeds are deposited to that account. For example, an auction will not issue a check to an individual, but will issue the check in the individual's business name. The check will normally bear some restrictive endorsement on the back, such as, "For Deposit to Account of Payee Only." Many auctions request a copy of a dealer's check to verify with the bank that the dealer actually has an account there.

Since the auctions guarantee that vehicle titles are lien-free, the auctions handle all title issues to ensure that the transfer is made correctly. Some common title problems include incorrect VIN, unsatisfied liens, incorrect title assignments, and an incomplete chain of title. The auctions have a great deal of experience with interstate

transactions and generally have a very good working relationship with the various states Motor Vehicle Divisions.

### **Titling Issues and Processes**

Titling procedures are determined by state law; thus there are 50 different sets of rules that apply. The state Division of Motor Vehicles, or similar agency, regulates the issuance and transfer of a vehicle's 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 particular state. In most states dealer-to-dealer transfers of title are accomplished through dealer reassignments. These reassignments are not usually recorded unless the state issued the original title or is recording the title once the vehicle is ultimately sold to a retail customer. All of these issues are compounded by the tremendous amount of interstate sales that occur. Although the use of state title transfers does have drawbacks and cannot be used to reconstruct or determine all of a dealer's sales, it remains a useful tool in checking the accuracy of reported sales. Despite no uniformity in titling rules or procedures, some very basic elements exist in all states:

- Every vehicle must have a title,
- There must be a written record of the sales transaction given to a customer,
- A title must contain certain specific information, although the contents will vary from state to state,
- A valid title must be produced in connection with a sale, but some exceptions exist for old vehicles in some states,
- Only dealers can reassign title, individuals cannot reassign titles.

Generally, title to vehicles purchased at an auction is reassigned 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. Some dealers may also purchase vehicles purchased in Canada. Canadian titling laws are much different from those in the United States, and advice on procedures should be sought from an international examiner, who can put you in contact with the Revenue Service Representative for Canada. Do the same with any dealer transactions in Mexico.

In most states, dealers need not take actual title to a vehicle, but can reassign the title. This may be done 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**

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, where the title is reassigned to the North Carolina dealer who acquires the vehicle. That dealer then sells the vehicle to a Florida dealer with a reassignment of title.

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. The notice may show all of 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 being sold in their state. However, each dealer should have a deal jacket for the transaction involving the vehicle.

### **Initial Interview**

The initial interview is crucial in all examinations. When examining an independent used vehicle dealer, as with all other examinations, the standard interview questions are required. There are a number of **specific** industry-related questions that should also be included as part of the interview process.

### **Sales:**



1. The examiner may want to ask the owner if he keeps a personal record or list of his or her profits on each vehicle or deal.
2. What types of sales transactions did you have for the year under examination?
3. Any sales at auctions? If yes, which?
4. Any sales to wholesalers? If yes, which?
5. Any sales to other dealers? If yes, which?
6. Any consignment sales? If yes, volume?
7. Any scrap sales? If yes, describe.
8. Any in-house dealer financing sales?
9. Any third-party financing sales?
10. Did you have any other types of sales transactions?
11. Did you have any sales that resulted in a loss on the sale? If yes, describe the nature of these sales.
12. Interest income on dealer-financed sales?
13. Commissions or referral fees on third-party financing?
  - What third party financiers did you use?
  - What was the fee/commission arrangement?
  - Commissions or referral fees on vehicle insurance placement?
  - Which insurance companies were used?
  - What was the fee/commission arrangement?
    - Commissions or referral fees on warranty/repair placement programs?
    - What other commission/referral fee arrangements do you have income from?
14. How Sales Are Recorded?
  - When selling a vehicle, how do you report the sale?
  - Gross sales price per Sales Contract?
  - Net cash received upon sale after discount and/or trade-in?
  - Through the use of a sales contract made in the year under examination, show me how you recorded the sale.
  - 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 so, make the appropriate adjustment.)
15. Do you sell warranty or service contracts?
  - How do you record the income from them on the books?
  - How do you record the expense items on the books?
  - Note: Be attentive to proper timing of Income/expenses.
16. Do you finance sales?
  - How do you record the income from the financing on the books?
  - Note: Be attentive to proper timing of income.
17. Do you sell finance contracts?
  - How does this transaction work?
  - Who do you sell finance contracts to?
  - Have the taxpayer walk you through a specific example?
  - Do you own or are you a shareholder of the finance company?
  - If the owner of the vehicle dealer is also an owner of the finance company, see Related Finance Companies under Accounting Methods, for additional information.
  - Do you have a dealer reserve account at any financial institution?
18. What other goods or services do you provide in your business? How are these transactions reported on the books?
  - Vehicle repairs?
  - Porter/detailing services?
  - Vehicle mats, etc.?
19. Pricing Policies and Discounts
  - When setting an asking price for a vehicle, what information sources do you consult, for example, Blue Book?

- When valuing a trade-in vehicle, what method do you use, that is, resale value to a customer, wholesale value to another dealer, or some other method such as personal judgment. Please explain the method by giving an example?
  - How do you arrive at the amount of discount you recognize on a sale?
  - Please provide an example.
20. When overvaluing a trade-in how do you record it on the books? How do you record this paper loss?
21. When recording a sale of a trade-in on the books, how are the ACV and the discount recorded on the books?

### **Inventory Items**

1. When setting an inventory value for a vehicle, what information sources do you consult, that is, Blue Book?
  1. Do you ever change this value?
  2. How is this change in value recorded on the books?
  3. What factors are considered when changing the inventory value?
  4. Do you always use one official valuation guide or do you consult more than one? Please explain. (Methods of fixing values differ among valuation guides. See Treas. Reg. section 1.446-1(a) (2))
  5. 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. (The propriety of a write-down may be determined by actual sales price. See Treas. Reg. section 1.471-4(b))
2. If a vehicle is portered or repairs are made to it for resale, how do you record these costs?
  1. Current expense?
  2. Added to the value of the vehicle?
3. When junking a vehicle for scrap, how do you account for it?
  - What value is used for vehicles in ending inventory?
  - Does this value differ from the one originally recorded at the time of acquisition?
  - In determining the yearly LIFO index, what is the vehicle in ending inventory compared to in the ending inventory of the preceding year (that is, the taxpayer's own cost for the same type of vehicle or a "reconstructed" cost from an official valuation guide for the same type of vehicle at the beginning of the year)?
  - Explain how these vehicles are comparable.

### **Miscellaneous**

1. Have you ever taken items other than vehicles in trade? Please explain.
  - How was this accounted for on the books?
2. Explain the titling regulations that you are responsible for as a licensed vehicle dealer.
3. Provide your log/record of titles for all vehicles sold for the year.
4. Do you acquire vehicles at auctions?
  - If yes, which auctions?
  - Which, if any, are out of state?
5. Do you acquire vehicles from wholesalers?
  - If yes and a few are used, which wholesalers are used?
  - If yes, and many are used, who are the primary wholesalers?
  - What out of town wholesalers do you use?
6. What other non trade-in sources of vehicles do you utilize?
  - What business names do they operate under?
  - Are any of these businesses out of state?
  - If yes, which ones are out of state?
7. How can I identify how a vehicle was acquired for resale?
8. How do you gauge the used vehicle market at any given time?
9. How does this affect your pricing and valuation practices?

If you use a vehicle for business, what records do you keep?

## Books and Records

### Accounting methods

Used car dealerships normally maintain an inventory, which is a material income producing item. Material income producing items are required to be accounted for under an accrual method of accounting. Nationwide, many used car dealerships have been found to be using an improper accounting method, either the cash method or the installment method.

- IRC section 448 places limits on the use of the cash method of accounting.
- IRC section 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.

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.

## Income

### Income reporting

There are certain issues in dealer income recognition that agents should consider during an audit. These include:

- Not recording a trade-in on a sale, then selling the trade-in for cash. One way to avoid reporting all sales is by cash sales in which a trade-in is sold directly to a third party. The dealer takes 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 dealsheet 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.  
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. However, substantial discounts are frequently given by dealers to get rid of overage vehicles, where a cash (no financing) sale occurs or in similar situations.
- Reporting net sales based on financing obtained, omitting cash received. Comparing the sales contracts with the financing files should disclose this problem. Also, the state sales tax can be used to determine the sales price, which should include any cash paid.
- Not reporting the sale of all cars purchased. 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. Also, a review of claimed travel expenses can lead to information about auctions attended where possible purchases occurred or sales were made. However, dealers may attend auctions where they make no purchases or sales.
- Purchasing a group of cars, allocating the entire purchase price to only some of the units; then selling one or more units off the books. A review of the purchase documents may provide evidence of the number of cars purchased. Furthermore, an analysis of the cost assigned to the inventoried cars acquired in the package should be made for reasonableness. However, it is common for the buyer to assign a different value to each car in the group than the seller has assigned. The buyer is not privy to the seller's allocations, and generally bases his or her allocation on the relative value of each vehicle in the group.
- Purchases from other dealers are generally similar to 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 ACV of each car to the total purchase price. 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 in the package enough to accept the entire package. As with cars purchased at auctions, the cost of the car will be increased by any reconditioning costs incurred in preparing the car for sale.
- As mentioned above, dealers may purchase — “clunker” cars as part of a package deal. The dealer may know this at the time of purchase, in which case a low market value will be placed on the inventory value

of the vehicle. At other times, a dealer will not realize it bought a "clunker" until reconditioning has begun. At this point in time, the dealer has two likely options:

- Sell the car from his or her lot, or
- Sell the car at an auction.

Either way, the likely result will be a loss on the sale of the vehicle and no further transactions with the other dealer.

- Other methods dealers may use to avoid reporting all income is to purchase four cars from another dealer or at auction. The purchase document will show four cars purchased. The dealer then books three cars into inventory and sells the fourth car without reporting the sale on his or her books. If such activities are suspected, check with the auction house as a third-party source.
- The independent used car dealer may take almost anything as a trade-in. Boats, trailers, snowmobiles, campers, etc. may be accepted as a trade-in. 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.
- Vehicles taken in as trades may not be issued a separate stock number. It is a common industry practice for the new trade-in to be assigned a stock number that is based on the original stock number. For instance, a car with stock number 122 is sold and a 1988 Plymouth is taken in as a trade; the Plymouth will be assigned stock number 122A.
- In some parts of the country, used car dealers have been found to be members of bartering clubs. For example, in Wisconsin, a dealer may receive "points" from a bartering club based on the value of a car, which can be exchanged for services or goods such as mechanical or body work on cars purchased for resale. Such activities are frequently not included as income.
- Many dealers engaged in "Buy Here/Pay Here" operations might repossess the same vehicle several times before it is ultimately sold. The dealer reports the gain on the first repossession, but not on the subsequent repossessions.
- Some state Departments of Transportation/Motor Vehicle require all car dealers to maintain a record book of all used cars purchased and sold. The details of this requirement are discussed in the section on inventory valuation. 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. In some states, such as Virginia, the number of dealer plates issued by the state is based on gross receipts. Some other states issue plates based on the number of salesmen or units sold. Wisconsin and other states will allow a dealer to have any number of dealer plates, as long as the dealer pays the fees for them. If your 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.

### **Automobile Sales**

Used vehicle sales, obviously, are the principal source of income of a dealer. The sales of autos will generally be 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.

Generally, sales proceeds from an auction will be paid to the dealer by check 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. If more than \$10,000 is received in cash, the dealer will be required to file Form 8300, Report of Cash Payments over \$10,000 Received in a Trade or Business.

The ultimate determination of the sales price will depend on a number of 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. Thus, 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. For example, an individual

who is willing to accept the 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**

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.

- Customer #1 has negotiated final sales price of \$3,500, with a \$2,000 cash payment and a trade-in allowance of \$1,500 which 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.
- 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. For the second customer, on the identical vehicle, the final net sales price will be \$3,750 (\$2,000 + \$1,750) to take into account the \$250 over-allowance. In each of these cases, the gross profit is \$500; however, the sales price and trade allowances are different. Furthermore, in each case, the cost of the trade-in for inventory purposes will be \$1,500.

The proper accounting entry to record a sale with a trade-in is as follows using the gross sales price (using the example above):

	<b>CUSTOMER 1</b>		<b>CUSTOMER 2</b>	
	DR	CR	DR	CR
Cash		2,000		2,000
Discount		400		150
Overallowance				250
Purchases or Inventory		1,500		1,500
Sales	3,900		3,900	

Notice that the only difference between these two transactions is that for Customer #1, the dealer combined the overallowance and discount into one account, rather than maintain separate accounts for each type of discount.

Note that a dealer may also account for the sale as a net sale, in which case the discount and overallowance would be netted against the sales price, and the net figure recorded as the sales price.

Many dealers sell service or warranty contracts at or close to the time of the sale of the vehicle. These service/warranty contracts are most often third-party obligor contracts, with the dealer receiving a commission for the sale.

Some dealers have begun to establish separate related companies to sell these contracts. There are several business reasons to establish a separate company to sell the contracts. Liability can be isolated in a separate entity, ownership of the separate entity can be spread among employees or family members, and any problems associated with the sale of these contracts can be handled without jeopardizing the vehicle sales business. There are no inherent prohibitions against using a separate company for this business, and there are normally no additional costs that are incurred above the normal costs of creating a new entity.

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.

Not all dealerships have all of these secondary sources of income, but it is common for a dealer to have one or more of them. Generally, secondary sources of income are listed on the customer file.

Used car dealerships may also provide other income-producing services. These services include body repair work and routine maintenance such as oil changes and tune-ups. Leasing used cars on plans similar to those of new car dealership has become another source of income for used car dealers in certain parts of the country.

Dealers may also buy vehicles that are later scrapped or junked. When this occurs, it is common for parts from the junked car to be used to recondition other cars that are eventually sold to customers. A dealer may also buy cars that are already scrap cars (also called junked cars) for parts that are used to recondition cars for sale to customers. The parts taken from a junked car may be used to recondition several cars (for example, the carburetor used for one car, the alternator for another). However, it would be unusual for the parts to be sold to third parties, since there is no network for such parts. A proportionate cost of the parts used should be added 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 should be recorded on the dealer's books, although the amount of such income is usually very small, normally under \$50 per car. Not many dealerships regularly purchase scrapped or junked cars due to space limitations and the bad appearance that the cars make on the dealer's lot.

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, large items such as television sets and stereo equipment may occasionally be given away. 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 of time. These prizes are also gross income.

### **Fee Income**

Auction fees are payments collected by a dealer for purchasing a particular vehicle for a customer at auction. Some dealers will bring the customer to the auction, although the dealer may have his or her buying card revoked by the auction if caught doing this. Other dealers will take a description of the vehicle as an open "buy order," then buy the particular type of vehicle when it goes through the auction. Many states have licensing requirements that make it illegal for some of the dealers to purchase a particular vehicle for a customer at auction. Dealerships caught in such activities will not only lose auction privileges, but may also have their dealer license revoked.

Typical auction fees are paid by the customer, not the auction, and range from \$150 to \$350, depending on the cost of the car, relationship with the customer, etc. The dealer may be reluctant to admit this type of income as the activity is discouraged by the auction.

The best way to check for auction fee income is to obtain a print out 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 "sleds," 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. Bird Dog Fees are a form of commission payment also known as finder or referral fees. These fees are generated by:

1. Serving as a broker between two dealers/wholesalers, etc.
2. Finding a retail buyer for another dealer.

These fees are often paid in the form of a check written directly to the dealership or in cash. Many dealerships will claim these fees as an expense, but very few dealerships claims the income. One examination uncovered \$32,000 in broker fees for sales between dealers, none of which was reported as income.

### **Rebate Income**

Dealerships may offer life insurance and disability insurance to buyers at the time of sale. The insurance policies are generally purchased from unrelated insurance companies, with the dealer receiving a commission from the sale of the insurance. There is very little self-insuring through related insurance companies in the industry, due to

the complexity of meeting the definition of an insurance company, and complying with the multitude of regulations set up by state insurance commissioners.

Referral fees from an insurance agent or agency are typically paid to the individual who made the referral rather than the dealership. The commission may be in cash, bartered insurance coverage, trips, etc. Such income can be found by reviewing either the deal files of the year under exam, or current deal files. Look for a particular agent writing most of the coverage.

Credit life and disability insurance (CLI) is usually offered in conjunction with financing and provides that if the insured event happens (that is, the buyer dies or becomes disabled), the buyer's note will be paid off by the insurance company. The commissions may range from 30 to 50 percent. If offered, CLI should be a large source of income.

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.

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. Michigan law is violated if it can be shown that the dealer controls or manages the insurance company.

Auto dealerships in Michigan and states with similar laws may not deduct under IRC section 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 in connection with the sale of CLI.

If you are unsure of the laws regulating the sale of insurance by auto dealerships in your 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.

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.

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 that records the reserve as a liability to the dealer because the dealer has a fixed right to receive the reserve even though not until a later year.

To find if income from finance rebates exists, look at the dealer agreement with the finance company, loan proceeds and recorded income. The dealership should be asked to provide account statements to determine the transactions in the reserve account. A listing of contracts financed, the amount financed and the withheld amount should also be reviewed. Review the title work or lien, checking for common finance sources. If the dealer records deposit sources, you may be able to spot check the deposit slips.

Some dealers sell a lot of "sleds," which often have had some body or paint work. Also some dealers specialize in insurance rebuilds. It has been a common practice for body shops to inflate the costs of repairs and rebate the difference to the owner in cash.

### **Warranty Contracts**

Used car dealers sell two basic types of extended service contracts. The first type, which is known as third-party or Administrator-obligor contract, is between the customer and an unrelated underwriter. The dealer is merely an agent for the underwriter and keeps as profit the difference between the sales price of the contract and the "cost" paid to the underwriter.

The second type is a contract between the customer and the dealer (known as a —Dealer-obligor contract). In the case of a dealer-obligor contract the dealer may buy insurance covering his or her risk or be "self-insured." If the dealer buys insurance, the income and expenses should be reported according to Rev. Proc. 92-97, 1992-2 C.B. 510 and Rev. Proc. 92-98, 1992-2 C.B. 512. If the dealer is "self-insured," the sales price of the contract should be reported as income in the year the contract is sold and expenses deducted in accordance with provisions of IRC section 461(h).

Dealer-obligor warranties are more profitable. The warranty accounts need to be carefully examined for proper reporting of income and expenses.

### **Consignments**

Some states allow dealers to sell vehicles on consignment. In these cases an individual may contract with the dealer to sell the vehicle. The individual receives a stated price upon the actual 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. There are two different practices for recording the cost aspects of the consigned vehicles.

In the first and preferred method, when the consignment agreement is entered into, a stock number is assigned to the vehicle. Costs incurred in prepping and repairing the consigned vehicle is posted to its assigned stock number. The stock numbers assigned to 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 consigned vehicle is then assigned another stock number to reflect the stated price to be paid the owner, and the reconditioning costs are transferred to the new stock number. Under the second method, a stock number is not assigned until the sale of the consigned vehicle actually occurs. In either method, incidental and reconditioning costs incurred by the dealer are deducted from the stated price paid to the owner. Many dealers also treat consignment sales from other dealers differently than consignment sales from the general public. Consignment sales from the general public are more detailed in the dealer's books because of titling concerns.

### **Dealer Financing**

Dealers commonly receive commissions on sales of financial products. Some dealers make arrangements with finance companies to provide financing for their 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.

Dealers may also have gross income from a rate spread on a loan. A dealer may have made arrangements 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 would be paid to the dealership by the finance company and would be 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.

A dealer financing his or her own sales (Buy Here/Pay Here Lot) generally collects on the buyers note in one of two ways. First, he or she will get monthly or weekly payments over the term of the note. The portion of the monthly or weekly payment reflecting interest is income to the dealer. The principal portion of the payment will reduce the receivable since the sales income has already been recognized at the time of sale.

Alternatively a dealer may sell a note or a number of 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. The dealer may continue to have secondary liability for the note (a recourse note).

The discount is deducted at the time that the note is sold since the dealer is not entitled to any more collections on the note, and the usual accounting entry on a \$5,000 note sold for 20 percent discount is:

	<b>DR</b>	<b>CR</b>
Cash		4,000



Discount on Note		1,000
Notes Receivable	5,000	

A detailed discussion of the sales and discounting of note receivable can be found in the Related Finance Company section.

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).

### **Sales taxes, registration and licensing fees**

Sales taxes and registration/license fees are collected by the dealer and paid to the state. 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, autos with a lien will be charged an additional fee to register the lien. The lien fee is normally passed on to the customer. New license plates may or may not be required when the vehicle is sold, 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 are applied 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.

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

#### **Repossessed vehicles**

Repossessions are common in the used car industry. When repossession occurs, the industry practice is to bring the car back into inventory at the vehicle's ACV, determined by the N.A.D.A. blue book or other Department of Transportation approved valuation guide. Likewise, the defaulting buyer receives a credit against the balance due for the ACV of the car. Alternatively, the dealer may obtain bids from other dealers or simply sell the car at an auction. In those cases, the buyer is credited with the net sales price of the car. State law often controls what the dealer can do with repossession, how the repossessed car should be valued, and what sales procedures must be used to sell a repossessed car. Accordingly, where the dealer has substantial repossessions, state law on repossessions should be reviewed. Repossession costs increase the basis of the car. These costs can include attorney's fees, repossession fees, repair costs and re-title fees. Small dealers may have better experience with repossessions than the larger dealers because they see it as a moneymaker, or they require a larger percentage of the purchase price as a down payment. 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. A \$1,200 deficiency exists. 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.

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 will also resell the car, either in a private sale or at public auction. If the sales price is less than the ACV credited to the borrower, the dealer may attempt to collect the difference from the buyer. Likewise, if the sales price exceeds the ACV credited to the buyer, the deficiency is reduced by the excess of sales price over ACV. If the repossessed car is sold with an overage (sales price exceeds the amount owed the dealer), the overage is repaid to the owner of the vehicle. Such requirements vary from state to

state and may be shown on the contract. Many dealers will create a new stock number for the repossession, while others will reassign (restock) the old number.

When a sale of personal property is reported under a deferred payment plan, the gain 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 basis of repossession is the FMV 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 only part of the obligation is discharged by the repossession, figure the basis in that part.

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 than the Actual Cash Value, which is based on adjusted wholesale values.

### **Purchases from Other Dealers**

Purchases from other dealers are generally similar to 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 Actual Cash Value (ACV) of each car to the total purchase price. 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, the cost of the car will be increased by any reconditioning costs incurred in preparing the car for sale.

### **Cost of Labor**

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.

### **Other Costs**

Other costs may include reconditioning, parts, delivery, detailing, outside services, repairs, and subcontracting. This is another area in which capital or personal items may be hidden.

### **Reconditioning Expenses**

A dealer will generally have substantial reconditioning expenses. These are the costs that must be incurred to get the traded car ready 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. The cost of reconditioning each car should be added to the inventory cost of the car.

### **Remanufactured Cores**

If your dealer is engaged in servicing vehicles for repairs and/or warranty work and even reconditioning, he or she may purchase remanufactured parts (for example, carburetor, alternator). Generally, the price of the remanufactured part includes a charge for the "core." This is an amount that will be refunded to the dealer once the old part is returned. If the dealer has any cores on hand at year-end, they should be inventoried. For example, a part may cost \$100 divided into two costs: \$70 for the cost of rebuilding the part and a \$30 core charge. The \$70 may be an inventoriable cost if part of reconditioning a vehicle or a current expense for repairs or warranty work. The \$30 is inventoriable separately with other parts until the core is returned for credit. Although it is improper, the dealer may expense the entire \$100 when the part is purchased and include the \$30 core charge as income only when the core is returned.

### **Inventory Valuation**

Inventory valuation is a complex issue for a used car dealer. A dealer generally buys used cars from new car dealers, other used car dealers, wholesalers, or at auctions. In addition, a dealer also acquires cars when he or she sells a car and takes a trade-in. The cost of the vehicles will be increased by the costs incurred to prepare the car

for resale. However, the method of determining the initial cost of an inventoried car will vary, depending on the source of the purchase.

### **Accounting records**

The industry custom is to maintain a file of cars in inventory by stock numbers. A stock number should be assigned as each car is purchased. A list of the stock numbers on hand is maintained. The stock number of the car will be recorded in the customer file at the time of sale. The dealer will note other dispositions of the cars, for scrap, at auction, etc. Special issues arise for consigned cars, as discussed later. Many smaller dealers do not assign stock numbers to their inventory, since the amount of inventory on hand at any given time is small.

Most dealers turn inventory quickly, selling acquired cars to retail customers, other dealers, wholesalers, or at auctions. Cars are sold at auction if the car is not sold off the lot in a very short period of time (90 to 120 days). It is also common for dealers to use the periodic inventory method, whereby inventory is taken at the end of the year. This is particularly true where lower priced cars are involved. It is also an industry custom to use the lower of cost or market method of inventory valuation. This usually results in some adjustment at year-end being made to the inventory. This adjustment may increase or decrease the cost of goods sold, depending on the inventory level.

### **Accounts receivable**

While new car dealerships have very detailed receivables and separate schedules for each type, the independent used car dealership may have no detailed receivable information. Many used car dealer returns show no account receivable. They will not accept any terms other than cash on delivery of the vehicle. Others may allow selected buyers to pay a portion of the purchase on delivery and accept payments for the rest. The full amount may not be shown in gross receipts when the sale is made. Frequently, the sales are recorded as the payments are received. The balance due may be kept in a separate book, index cards, or recorded on the deal-sheets. IRC section 453 does not permit the deferral of income from an installment sale for a dealership that regularly sells or otherwise disposes of personal property.

The absence of accounts receivable or an unusually low amount may indicate that the dealership has discounted its receivables. See the Related Finance Companies section for information concerning discounting of accounts receivable.

### **Issues**

- Are all sales reported?
- Are all sales reported in the proper tax year?

### **Audit Techniques**

1. Sample deal sheets, checking for terms of the sale.
2. Review sales recorded in the opening days of the next tax year to determine whether sales are includible in the year under examination.
3. Determine whether the full amount of the sales price involving payment plans was recorded as income at the time of the sale.

### **Trade-ins**

Some of the most complex inventory issues arise in the valuation of trade-ins. These complexities arise because the amount allowed as the trade-in does not usually equal the ACV, which is the initial inventory cost to the dealer. Various factors make the determination of value very difficult.

### **Cost Basis of a Trade-in**

The starting point for determining the cost of a car taken in trade is the Actual Cash Value (ACV). It is a common industry practice to determine the ACV by the following steps:

- Refer to a valuation guideline. While the Kelley Blue Book and N.A.D.A. Used Car Guide are two of the more common valuation guidelines, any guideline approved by the Department of Transportation is acceptable, including Auction guidelines. However, these books serve only as the starting point, as a guideline for the value of the car. Even the valuation guidelines point out that adjustments must be made for the actual condition of the car, since the guideline assumes an average condition. Many dealers may not

- follow proper tax procedures through the use of a published guideline, instead basing their determination on the actual market conditions existing at that time in their location.
- The dealer will then adjust the value to take into account specific features of the car that add to or subtract from the guideline value. Some of these factors include:
    - Actual wear and tear on the car,
    - Mileage,
    - Accessories,
    - Any hidden damage such as frame damage,
    - The cost of complying with Environmental Protection Agency (EPA) requirements,
    - Whether the car has been in an accident.
  - The dealer will also consider another intangible factor, the market conditions. This is a factor to carefully examine because it deviates from valuations provided in the published guidelines. For example, a convertible offered as a trade in November may have less value than one offered as a trade in April or July, since the opportunity to quickly resell the convertible depends on the season. (Clearly it is harder to sell a convertible when snow is falling than it is on a warm spring or summer day). There are three problems with this type of write-down:
    - The actual cash value of the convertible will not change dramatically between November and December.
    - The car can be sold in a warmer climate for what it is worth, or more, because of greater demand for convertibles in warmer climates.
    - Tax law will not allow a write down of a vehicle when the facts show it will be worth substantially more only 4 or 5 months later.
    - Other conditions such as the overall market for the particular car being offered for sale, safety recalls, or changes in the automobile industry can all impact the value of a car.
  - The value of the car is then adjusted for reconditioning costs and other expected expenditures that the dealer will have to make to get the car ready for resale. Some common expenditures include:
    - Cleaning the car
    - Mechanical repairs
    - Body damage repairs
    - Interior and upholstery repairs
    - Safety inspection
    - Required state inspection
    - Emissions control inspection
    - Painting
    - Tires
    - Finder's Fees.

### **Trade-in Valuation**

The valuation of a trade-in is an art, not a science. This outline of the valuation process may or may not be followed by a particular dealer. Many dealers, for example, 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. However, every dealer values a car for the sole purpose of making a profit on both the cars in inventory and the trade-in, when it is ultimately sold. Revenue Ruling 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). Prices, which vary materially from the actual market prices during this period, will not be accepted as reflecting market.

Some Dealerships may undervalue their year-end inventory to overstate the cost of goods sold by using unacceptable methods of valuation. For example, it is common for dealers to use personal knowledge and year-end auction prices for similar cars as the means of valuing inventory. The reason given for using auction value is that this is the price one could get for their cars if forced to sell the inventory at auction and close the business. However, this may not be the dealer's primary market and would be an unacceptable valuation method.

Dealers may also try to 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.

While the industry may recognize the use of experience and personal judgment to 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 ruled that an officially recognized valuation guide would be accepted for tax purposes. See *Brooks-Massey Dodge, Inc. v. Commissioner*, 60 T.C. 884 (1973) and Revenue Ruling 67-107, 1967-1 C.B. 115 under references in this section for more information concerning proper inventory valuation.

Once the ACV of the trade-in is determined, then the trade-in allowance that will appear on the sales contract must be negotiated with the buyer. These negotiations often result in an over-allowance, for various reasons. As indicated earlier, the sales price is usually adjusted to take the over-allowance into account. Properly determining the ACV of a trade-in is critical to the dealer's success since the profit on sale of both the inventory and traded vehicles will ultimately be determined by how accurate a value is placed on the trade-in.

A problem may arise when there is a loan outstanding on the trade-in. Some transactions will be upside down, with the outstanding loan amount greater than the ACV of the car. In those cases, the dealer will give the buyer a trade-in allowance equal to the loan balance. The excess of the loan amount over the vehicle's ACV is an over-allowance which, in the industry, is treated as a discount to the sales price. The dealer will pay off the outstanding loan balance.

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.

Some dealers will use a perpetual inventory method, whereby the inventory account is updated 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. Adjustments to the inventory account and cost of sales may be made throughout the year, or one adjustment may be made at the end of the year. A majority of dealers will take a periodic inventory, usually at the end of the year, and adjust the purchase, inventory and cost of goods sold accounts at that time.

When dealer uses the periodic inventory method, a physical inventory is taken at year-end. The dealer may write the inventory down at this time 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.

Year-end write-downs on used vehicles are allowable when certain requirements are met. Revenue Ruling 67-107 allows a car dealer to value his or her used cars for inventory purposes at valuations comparable to those listed in an official used car guide adjusted to conform to the average wholesale price listed at that time. (See also *Brooks-Massey Dodge, Inc.*, 60 T.C. 884 (1973). Although this is a practice recommended by the industry and used by nearly all car dealers, there are some additional requirements.

Treas. Reg. section 1.446-1(a)(2) states in part that a method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income. Treas. Reg. section 1.471-2(d) provides that the method must be applied with reasonable consistency to the entire inventory of the taxpayer's trade or business. There is a lack of consistency if more than one official valuation guide is used simultaneously.

IRC section 471 provides that inventories must conform as nearly as may be to the best accounting practice in the trade or business and must clearly reflect income. These regulations under IRC section 471 prescribe two instances where inventory may be written down below cost to market. The first instance allows a taxpayer to write down purchased goods to replacement cost (Treas. Reg. section 1.471-4(a)). The second instance is contained in Treas. Reg. section 1.471-4(b) which states in part that inventory may be valued at lower than replacement cost with correctness determined by actual sales for a reasonable period before and after the date of

inventory. Prices, which vary materially from the actual market prices during this period, will not be accepted as reflecting market. (See also *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979) and *Pearl v. Commissioner*, T.C. Memo 1977- 262.)

## Expense Issues

### Commissions and fees

Many used car dealerships are operated solely by their owners, so the dealership will not have commission expenses for payments to drivers. In cases where the dealership employs salespeople, the salespeople likely will receive commissions, which are considered wages and salaries for employment tax purposes from the sales of vehicles. Contracts between employer and employee should specify how commission wages are determined.

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. A Form 1099 Miscellaneous must be issued if the amount paid to an individual is over \$600.

Dealers may incur charges referred to as "hiking" or "shuttling" for the transportation of vehicles. Generally, these expenses are paid to individuals who are hired to drive cars between dealers' lots and to or from auctions. These costs should be inventoried under IRC section 263A if they are associated with moving or shipping property acquired for resale.

They also may be subject to employment taxes, depending on the facts and circumstances. In *Leb's Enterprises, Inc.*, 85 AFTR2d Par. 2000-450, January 24, 2000, Car Shuttlers Drivers that transported vehicles from place to place were employees of the company and the company was responsible for applicable employment taxes.

### Demonstration expense

Generally a used car dealer will not have any demo expense. It is likely that the owner of the dealership will 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 the sole proprietor should reduce expenses.

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. section 1.132-5(o). This section defines who is a full-time salesperson, and what is qualified automobile demonstration use. 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 sure the repairs were properly made, or he or she was driving the car around with a for sale sign as advertising. These arguments will have to be addressed on an individual basis, taking into account the facts and circumstances involved.

## Related Finance Companies

### Industry Overview

The use of related finance companies (RFC) is a common practice in the used car industry. Such companies serve many valid business purposes and were utilized before any tax advantage scheme was offered. However, some RFC's are being utilized by used and new car dealers to reduce or defer the reporting of income. This section of the guide is to be used as an overview of RFC's. In it will be found reasons for establishing RFC's, and issues faced in the examination of an RFC issue.

There are three issues that exist in dealing with RFC's. The first involves the economic reasons for the arrangement, the second involves the validity (form) of the RFC itself, and the third and most critical issue involves the economic substance of the discounting transactions.

### Economic reasons

There are several reasons for creating and using an RFC. The following are some of the major reasons that an RFC is created. Each of these reasons can provide a significant and valid business and economic reason for

creating a separate entity to finance the dealer's receivables, even if no third-party receivables are acquired. There are other equally valid and legitimate reasons for using an RFC.

1. 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 get credit elsewhere. In this way the RFC serves a useful purpose in providing credit to individuals with little credit, no credit, or bad credit. 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. Payment schedules are on a weekly or monthly basis.
2. 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 the third party is related to the dealer. It has been the industry's experience that when payment is made directly to the dealer; 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.
3. 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.
4. Preventing adverse publicity on repossessions and other collection actions from affecting the dealership.  
Repossession and collection problems are a daily fact of life 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.
5. Insulating 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. The default rate on buy here/pay here notes is substantially higher than on general bank loans. This economic fact is recognized in 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.
6. Diversification of ownership.  
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.

A final advantage is that an RFC can be expanded, depending upon the dealer's desire, to finance unrelated receivables as well as those of a particular dealership. It should be pointed out that although this is possible, it rarely happens.

### **Validity or Form of RFC**

The second issue that should be considered 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 to be treated as a separate, valid business. These criteria are:

1. The RFC should be a separate, legal entity.
2. The RFC should meet all licensing requirements of the jurisdictions in which it operates.
3. A major factor is that the RFC should be adequately capitalized in order to pay for the contracts.
4. The RFC should have its own employees and compensate them directly.
  - However, the fact that the RFC and the dealership or other related entities may elect to use a common paymaster does not indicate, that the RFC does not have its own employees.

5. The RFC should obtain and maintain all appropriate local business and similar licenses.
6. The RFC should have a separate telephone number.
7. The RFC should have a separate business address, which may be a post office box. Even if a separate business address is maintained, it is common for the RFC to have an office at the dealership.
8. The RFC should maintain a separate set of books and records.
9. The RFC should comply with all title, lien, and recordation rules in the jurisdictions in which it operates.
10. The RFC should notify customers of the purchase of their notes.
11. The RFC and the dealership should 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.
12. The RFC should pay the dealer for the receivables at the time of purchase. The RFC 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.
13. The RFC should be operated in a business-like manner.
  - While all of these attributes need not be present, to the extent that they are absent, a question as to the substance of the RFC exists.

### **Economic substance of an RFC**

The third and most important issue that should be addressed 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.

The FMV of a receivable or group of receivables will depend on a number of factors. Purchasing receivables are not an exact science, and many subjective factors enter into the determination of value. The industry's position is that a deep discount is warranted in nearly all transfers of receivables. The factors that 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.

Reviews of some third-party finance company documents indicate that these companies can offer to acquire the receivables from dealers at up to a 50 percent up-front discount. These discounts apply whether or not the finance company buys in bulk or "cherry picks" the best accounts.

It is also important to note that these same third-party finance company documents refer to back-end reserves. These back-end reserves can be released to the dealer at the time the loan is paid off. The back-end reserves can restore the dealers profit on the sale to 100 percent, less any transaction costs. RFC purchases at a deep discount should be inspected for these back-end reserves.

A dealer can use an RFC to discount its receivables and have it accepted for tax purposes. To summarize the above discussion, the following three factors need to be addressed:

- The discounting transactions must have economic substance. All of the relevant facts and circumstances must be considered. Remember that the primary reasons for selling receivables are to obtain cash (improve cash flow) or to shift risk. If both of these are missing, it is a good indication that the sales transaction lacks economic substance.
- The form of the transactions and the form of the RFC must be perfected.
- The receivables must be sold 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.

Among the issues that may arise are the following:

1. Whether there has been a change in method of accounting where a related refinance company is used to defer income.



2. Whether a loss incurred by a car dealer from the purported sale of notes receivable to a related finance company should be disallowed because the related finance company existed only in form and the transaction between the dealer and related finance company lacks economic substance.
3. Whether IRC section 482 applies to the loss claimed by a dealer from the sale of notes receivable to a related finance company because the notes receivable were sold at less than the fair market value.
4. Whether Internal Revenue Code section 267 disallows a loss from the sale of notes receivable by a car dealer to a related finance company.
5. Whether a dealer and related finance company are members of a controlled group for the purposes of IRC section 267 and thereby eligible for the special loss recognition rules of Treas. Reg. section 1.267(f)-1(f).

### **Issue Development**

Issue development is the key to any substance versus form argument. This is especially true when related companies are involved. Depending on the facts and circumstances of each dealership, the RFC could be a valid business and should be respected as a separate entity. Your issue will be resolved based on the particular facts and circumstances of your taxpayer. Accordingly, the importance of fully developing your RFC issue cannot be overstated.

### **What is a Non-Prime or Sub-Prime Finance Contract?**

Because of poor credit, many potential vehicle purchasers cannot obtain financing directly from banks, credit unions or manufacturers' finance companies. These individuals are 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 lenders who have dealers execute their own retail installment agreements to these customers. These contracts are known in the industry as non-prime or —sub-prime financing.

### **How a Non-Prime or Sub-Prime Plan Works**

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. 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. Upon transfer of the installment contract, the finance company pays the dealership an advance which may range from 50 to 75 percent of the contract, depending on the credit rating of a particular customer or the dealership's aggregate pool of contracts. The advance can be based on the face amount of the contract without interest, or the total contract amount including interest. 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 will be 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, known as the *BACK-END DISTRIBUTION*.

To summarize, 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)

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.

The chances of receiving back-end distributions are further reduced because the finance companies aggregate the installment contracts rather than carry them individually. For example, if a dealership transfers 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, as long as 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.

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 particular contracts are applied exclusively to those contracts. The collections on those contracts are not used to repay advances on contracts in another pool. 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 pools of the dealer that have been capped. 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. Non-prime and sub-prime arrangements are constantly changing, so it is difficult to provide a “one-size fits all” description of these products. Agents should consider all the facts and circumstances pertinent to a particular servicing agreement when examining these issues.

#### **What are the issues?**

The discussions in this audit technique guide are directed toward dealership reporting. No conclusions should be drawn from these discussions about the treatment of these contracts by finance companies.

There are several dealership issues associated with the tax reporting of non-prime and sub-prime contracts, including the following:

- Is the transfer of the contract from the dealership to the finance company a sale of the contract or merely a pledge of the contract to collateralize a loan made to the dealership by the finance company?
- How should the cash advance be reported?
- How should the payment of the fixed percentage collection fee be reported?
- Are back-end distributions contingent payments?
- When should the back-end distributions be reported?
- How should the back-end distributions be valued?
- How should interest be computed and reported?
- How should enrollment fees and capping fees be reported?
- Are adjustments to this issue changes in method of accounting?

Sub-Prime/Non-Prime Financing - October 1998; March 1999; March 1999; LTR 9840001; LTR 199909003; LTR 199909002

- 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 must be allocated to principal and interest.

#### **Income Tax Treatment**

Since inventory is a material income-producing factor, vehicle dealerships are required to use the accrual method of accounting. Often, however, dealers use the cash method to report the transfer of installment contracts to the finance company. They report only the customer down payment and the advance received from the finance company as current income. Back-end distributions are often reported in a later tax period, when received. The primary reasons these transactions are reported in this manner are because

1. They follow the actual cash flow, or economic reality, of the transactions, and

2. It is difficult to assign a value to money which the dealership does not know if, when or how much will be received. Transactions associated with non-prime and sub-prime financing must be reported on an accrual basis. However, it is important to understand all facets of the transactions to properly account for them.

Two separate transactions occur. First, the vehicle is sold to the customer. Second, the installment contract is transferred from the dealer to the finance company. The Tax Reform Act of 1986 repealed the installment method of reporting for dealers in personal property. Thus, the initial sale of the vehicle by the dealer to the customer must be reported in full the year the sale occurred. The total sales price of the vehicle must be reported even if an Installment agreement was executed. The dealership's basis in the vehicle offsets the total sales price to determine the gain or loss on the sale.

To determine the appropriate tax treatment of the second transaction, it must be determined if the transfer of the installment contract to the finance company by the dealer is a sale or a pledge to collateralize a loan from the finance company. No matter what the character or tax treatment of the second transaction, however, the initial sale of the vehicle to the customer must be reported in full in the year of the sale.

### **Sale, Assignment, Loan or Pledge to Collateralize a Loan**

Whether the transfer of an installment contract is a sale or a pledge to collateralize a loan made to the dealership by the finance company depends on the facts and circumstances. Many of the servicing agreements or other arrangements between the dealerships and finance companies are worded as if the finance company is loaning money to the dealership. However, a close review of the provisions of these agreements often reveals that in substance they are sales. The following factors tend to indicate the transfer is a sale. The number of factors applicable to a particular dealership, or the relative importance of one factor to another, must be considered in determining whether a sale, or some other type of transaction has occurred:

1. The terms of the transfer are nonrecourse; that is, the dealership is not responsible for payment of any defaulted notes or payments (often after 90 days).
2. The transfer gives the finance company unilateral power to dispose of the note
3. The dealership's security interest in the financed vehicle was transferred to the finance company.
4. The finance company receives all files and paperwork related to the customer note
5. The finance company handles all collections and other administrative actions on the customer note.
6. The finance company is entitled to endorse the dealership's name on any payments made to the dealership and any other instruments concerning the installment contract and the financed automobile.
7. The finance company determines whether the note is in default. The finance company can waive any late payment charge or any other fee it is entitled to collect.
8. The finance company can repossess and sell or otherwise liquidate the financed vehicle if default occurs.
9. The dealership's customers are notified the note will be assigned to the finance company.
10. The finance company may or does pledge the customer notes as security for its own indebtedness.
11. The finance company bears the credit risk on the customer notes.
12. The dealership is not required to provide financial statements to the finance company in a manner normally associated with a line of credit or other loan arrangement.
13. There is no stated interest rate, maturity date, or other specific details normally associated with a line of credit or other loan arrangement.

### **Treatment of a Pledge of Collateral (i.e. loan or an assignment)**

If the transfer of the installment contract to the finance company from the dealership is determined to be a pledge to collateralize a loan from the finance company, there is no income to the dealership upon receipt of the cash advance and no gain or loss is recognized at the time of the transfer of the contract. The cash advance is considered a loan. Collections by the finance company are treated in a dual manner since they must be applied to both the original installment contract between the purchaser and the dealership (which the dealership still owns), and the outstanding cash advance loan between the dealership and the finance company.

### **Dealership Note Receivable (from vehicle purchaser):**

Each collection by the finance company is applied against the outstanding installment note receivable still owned by the dealership. A portion of each collection is interest income to the dealership, and a portion is applied against the principal balance of the purchaser's note.

**Dealership Note Payable (to finance company):**

Since the amounts collected are actually retained by the finance company to apply against the cash advance balance outstanding, a portion of each amount collected is considered interest expense to the dealership, and the remainder applied against the advance principal balance. The fixed percentage collection fee retained by the finance company is current expense to the dealership.

It is anticipated that few, if any, of these transactions are likely to be true loans.

**Treatment of a Sale**

If the transfer of the installment contract to the finance company is deemed to be a sale by the dealership, the amount realized on the sale is compared to the dealer's basis in the contract to determine the dealer's gain or loss. Per Internal Revenue Code section 1001(b) the amount realized from the sale is the cash plus the fair market value of any other property received. This formula appears simple, but is actually difficult to apply. It is made more complex by the impact of Internal Revenue Code section 483, which requires deferred payments to be recharacterized in part as a payment of unstated interest.

The dealer receives cash in the form of advance payments. That is easy to quantify. However, the dealer also receives the right to back-end distributions. The fair market value of that right is difficult to determine, since these contracts relate to non-prime and sub-prime customers who do not have good credit and the back-end distribution payments are contingent upon the recovery of the upfront cash advances, collection fees and out-of-pocket costs. Thus, it is difficult to determine the amount realized from the sale of the installment contract by the dealer to the finance company.

There is significant debate over the appropriate valuation of the amount realized upon the sale of the contracts. Some argue that the full face value of the installment contract should be reported in the year of the transfer. Others maintain that although some back-end payments may be made, they will be de minimis and almost never match the remaining balance in the contract after cash advances and fixed percentage collection fees. Yet others insist that the possibility of receiving any back-end distributions is so remote it is almost moot, and the fair market value of the right to receive the back-end distributions is zero.

If the dealership primarily does business with customers having very poor credit and there is no historical receipt of back-end distributions, it MAY be reasonable to assign a \$0 fair market value to potential back-end payments.

If the dealership does have a history of receiving back-end distributions, these amounts should be determined from the monthly statements received from the finance company. A rolling average or some other type of methodology may be utilized to determine the fair market value of sales occurring in the tax years under examination and for the future.

The amount of back-end distribution recharacterized as unstated interest may also be difficult to determine. The regulation requires this amount to be determined by discounting the back-end distribution at the applicable federal rate from the time the applicable installment contract was sold until the back-end distribution is made. The regulations do not explain how to apply this rule when the back-end distributions are made on a pool of installment contracts. Similarly, the portion of a back-end distribution that is not unstated interest is a recovery of basis received from the sale of the installment contract and, if all basis has been recovered, is treated as gain from the sale. When the back-end distributions are made on a pool of installment contracts, it is not clear to which installment contract the recovered basis should be attributed. The following facts and circumstances should be considered when determining the value of the right to back-end distribution payments includible in the amount realized on the sale:

1. Has the dealer received any back-end distribution payments?
2. What is the amount of back-end distribution payments received?
3. How long has the dealer been involved in the program with the finance company?
4. Has the dealer capped any pools of contracts?
5. Are the pools cross-collateralized?
6. Has the dealer's involvement in the program with the finance company been terminated?
7. Has the finance company changed the dealer's collection rating since joining the program?
8. What is the historical rate of default for the dealer's customer base?

9. Has the current customer base changed?
10. How does the taxpayer value the right to back-end distribution payments?
11. Have the terms of the servicing agreement between the dealer and the finance company changed?

### **Audit Techniques**

At the initial interview, ask the taxpayer if any retail installment agreements for the customer purchases of vehicles are transferred to any unrelated finance companies. The taxpayer may use more than one finance company or switch from one finance company to another. Almost any finance institution, including major banks and financing arms of major vehicle manufacturers) may be involved with non-prime or sub-prime paper.

If you interview the accountant or preparer, he/she may not be aware that the dealer is transferring any finance contracts since the audit plan may not include reviewing vehicle jackets or supporting documentation. It is imperative that the dealer be asked directly.

### **Sub-Prime Records**

Ask the dealer to provide the vehicle jackets. These jackets are usually an envelope (or sometimes a file folder) for each vehicle, which includes all of the dealer's documentation related to that vehicle such as the sales invoice, purchase invoice, copy of the title, and repair receipts. The outside of the jacket often also lists detailed information about the vehicle's purchase and sale, including the dates, amounts, and individuals or companies involved. These jackets also may contain the dealer's records pertaining to the transfer of the installment contract to the finance company.

Look through the jacket for a retail installment agreement specifying how the customer will pay for the vehicle. Sometimes the retail installment agreement specifically states that it will be transferred 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. The dealer also prepares other paperwork as required by the finance company, copies of which have been kept and retained in the jacket or a separate finance file. This includes 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.

If it is determined that the dealer transferred finance contracts to an unrelated finance company, additional information will need to be requested for each company:

1. Servicing Agreement (also referred to as the dealer agreement). 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, an addendum or other notification of the changes may be provided to the dealer by the finance company.
2. Dealer Manual & Other Literature. The dealer Manual may contain various items of information, including a sample of customer paperwork with detailed advance computations. The finance company may also send the dealer literature on new programs or new features such as pool capping.
3. Account Statements -The finance company sends statements (usually monthly) to the dealer summarizing advances, collections, fees, and other pertinent information. The summary may also show detail by customer of the last payment date, amount of payment, and if the account was written off as a bad debt.

### **Example of Accounting Entries:**

The transfer of the installment contract to the finance company may or may not be recorded in the dealer's books. You should not rely on the presence or absence of accounting entries to determine if the transactions have been reported properly. The following provides representative examples of how you may find the transactions to be reported and how they should be reported:

### **FACTS:**

Sales Price                                      \$5,000    Sale Price by Dealer to Purchaser

Cash (Down Payment)	1,000	Down Payment from Purchaser to Dealer
Accounts Receivable	4,000	Installment Contract Recorded on Dealer's Books
Cash (advance)	2,000	Advance to Dealer from Finance Company
Cost of Goods	2,500	Dealer's Cost of Vehicle Sold
Monthly Payments	250	Monthly Payment per Contract
Interest Rate	10%	Rate of Interest Charged to Purchaser and by Finance Company to Dealer
FMV of BE Distribution	450	Potential Max Back-End Distribution of \$1200.

Fair market value of contingent contractual right to such payment estimated to be \$450.

**Report as a Loan or an Assignment...**

*(What You May Find On The Dealership Books)*

I. Note Receivable		<b>Debit</b>	<b>Credit</b>
Cash		\$4,000	
Sales (\$4,000 + 1,000 = 5,000)		\$1,000	\$5,000

To record the sale of the vehicle

II. Cost of Goods Sold (COS)		<b>Debit</b>	<b>Credit</b>
Inventory		\$2,500	\$2,500

To record the cost of the vehicle sold

**Sales - COS = Net Profit** (\$5,000 - 2,500 = \$2,500)

III. Cash		<b>Debit</b>	<b>Credit</b>
Advance Payable to Finance Company		\$2,000	\$2,000

To record advance received from the finance company

IV. Advance Payable to Finance Company		<b>Debit</b>	<b>Credit</b>
Notes Receivable		\$250	\$250

To record collections received and applied by the finance company to offset the advance

V. Cash		<b>Debit</b>	<b>Credit</b>
Accounts Receivable		\$100	\$90
Interest Income			\$10

To record back-end distribution payment from finance company. Amounts and interest rate estimated.

	<b>Debit</b>	<b>Credit</b>
VI. Service Fee	\$20	
Accounts Receivable		\$20

To record collections received by finance company applied to the service fee.

**Report as a Loan or an Assignment...**  
*(How It Should Be Reported)*

	<b>Debit</b>	<b>Credit</b>
I. Accounts Receivables	\$4,000	
Cash (down payment)	\$1,000	
Sales		\$5,000

To record the sale of the vehicle

	<b>Debit</b>	<b>Credit</b>
II. Cost of Goods Sold	\$2,500	
Inventory		\$2,500

To record the cost of the vehicle sold

	<b>Debit</b>	<b>Credit</b>
III. Cash	\$2,000	
Advance Payable to Finance Company		\$2,000

To record advance received from the finance company

	<b>Debit</b>	<b>Credit</b>
IV. Advance Payable to Finance Company (\$250-(17+50))	\$183	
Notes Receivable (\$250-33 = 217)		\$217
Interest Expense (Dealer to Fin.Co.) (2000*(10%/12))	17	
Collection Fee Expense (250*20%)	50	
Interest Income (Dealer held note) (4000*(10%/12))		33

To record collection of first \$250 payment

**Reported correctly, the dealership must include ordinary interest in its taxable income rather than applying all the payments as an offset to notes receivable.**

**Reported As A Sale...**

*(What You May Find On The Dealership Books)*

I. Note Receivable	<b>Debit</b>	<b>Credit</b>
Cash	\$4,000	
Sales (\$4,000 + 1,000 = 5,000)	\$1,000	\$5,000

Gain on Sale (Vehicle 5000-2500 = 2500)

Loss of Sale (Contract 4000-2000 = 2000)

To record the sale of the vehicle - (Gain on Sale of 2500 - Loss of Sale of 2000 = Net Profit of 500)

II. Cost of Goods Sold (COS)	<b>Debit</b>	<b>Credit</b>
Inventory	\$2,500	\$2,500

To record the cost of the vehicle sold

III. Bad Debt Expense	<b>Debit</b>	<b>Credit</b>
Cash (advance)	\$2,000	
Notes Receivable	\$2,000	\$4,000

To record the sale of the finance contract

**Note that instead of assigning value to the right to receive future back-end distributions and interest, a bad debt expense was taken to write off the dealer's remaining basis in the installment contract. This has a significant impact on the net outcome of the transactions, as shown above.**

### **Reported As A Sale...**

*(How It Should Be Reported)*

I. Note Receivable	<b>Debit</b>	<b>Credit</b>
Cash (down Payment)	\$4,000	
Sales (\$4,000 + 1,000 = 5,000)	\$1,000	\$5,000

To record the sale of the vehicle



II. Cost of Goods Sold (COS)	<b>Debit</b>	<b>Credit</b>
Inventory	\$2,500	\$2,500

To record the cost of the vehicle sold

III. Cash	<b>Debit</b>	<b>Credit</b>
Back-end Distributions Receivable	\$2,000	
Loss on Sale of Installment Contract	\$450	
Note Receivable	\$1,550	
		\$4,000

To record the sale of the finance contract

IV. Cash	<b>Debit</b>	<b>Credit</b>
Back-end Distributions Receivable	\$600	\$600

**Cash Flow Analysis**

Tax on Profit (Sale of Car):  $(2500 \times 30\% = 750)$

Tax on Loss (Sale of Contract ):  $(1550 \times 30\% = 465)$

**Reported properly, the correct loss is \$1550, not \$2000. Note that back-end distributions that are paid will include unstated interest calculated under the principals of Regulation section 1.483-4.**

## ***Direct Sellers***

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### **Introduction**

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.

The cost for an individual to start an independent direct selling business is typically very low (which is a major selling point for entering into this type of self-employment business). Usually, a modestly priced sales kit is all that is required for one to get started, and there is 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.

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.

### **Types of Direct Selling Companies**

There are two types of direct selling companies – single level marketing (SLM) or multilevel marketing (MLM). Single level marketing (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.

In a multi-level marketing company, sales representatives are able to 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. MLM’s are often referred to as network marketing companies.

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.

Pyramid schemes seek to make money quickly. Multi-level marketing companies seek to make money with their representatives as the business grows by selling their consumer products. Multi-level marketing companies have a start-up fee that is small with a starting sales kit being sold at or below the company cost. Multi-level marketing depends upon sales to the consumer and establishing a market.

## Demographics of Direct Sellers

Direct selling is a rapidly growing industry. U.S. sales totaled \$29.55 billion in 2003, up from \$28.69 billion in 2002, with more than 55 percent of the American public having purchased goods or services through direct selling. Direct selling globally has grown to more than \$85.04 billion dollars as well. For the 19th year in a row, this industry has grown in both the area of sales and sales force. The \$29.55 billion dollar of sales is more than the amount that was purchased through television shopping and on-line computer services combined.

Currently, there are an estimated 13.3 million people who are involved in direct selling in the United States and more than 47.3 million people worldwide. Most are women, though nearly a third are men or two-person teams such as husband and wife (couples). The vast majority is independent business people - 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. Of these 13.3 million people for 2003, approximately 90 percent of them operate their businesses part-time. The Small Business/Self-Employed Division serves each and every one of these 13.3 million direct sellers.

Why are Americans so interested in becoming direct sellers? Most are independent contractors; they have the ability to 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.

Since direct sellers do not need any specific amount of education, knowledge, or any specific requirement in order to be successful, they only need the desire and self-motivation to grow their business and make it profitable for them.

## What Direct Sellers Do

Just about every consumer product or service can be purchased through direct selling. But where is this direct selling taking place?

### *Location of Sales:*

	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>
<i>Face-to-face selling:</i>	78.26%	77.3%	76.1%	73.1%
In the home	64.4%	63.5%	62.8%	61.9%
In the workplace	8.7%	8.8%	8.9%	6.7%
At a temporary location: (Fair, exhibition, etc.)	4.1%	4.2%	3.7%	3.9%
Other locations	1.0%	0.8%	0.7%	0.6%
<i>Remote selling:</i>	21.8%	22.7%	23.9%	26.9%
Phone	14.7%	14.4%	15.1%	15.6%
Internet (www or email)	5.5%	7.2%	8.2%	10.8%
Other (mail, fax)	1.6%	1.1%	0.6%	0.5%

*Source: 2001, 2002, 2003, 2004 Direct Selling Association's Fact Sheet Growth & Outlook Surveys.*

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.

### **NAICS Codes and the Direct Selling Industry**

The North American Industry Classification System (NAICS) has replaced the U.S. Standard Industrial Classification (SIC) system. NAICS groups the economy into 20 broad sectors, up from the 10 divisions of the SIC system. The Code 44-45 is specifically for the Retail Trade sector.

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 sales clerks; facilities for making cash or credit card transactions; and services provided to retail customers.

Taxpayers are instructed to enter on the Schedule C or Schedule C-EZ a code which best describes the type of business activity that they participate in. Currently, a 6-digit NAICS code is entered.

The instructions to Schedule C list several NAICS codes relating to nonstore retailers. As discussed in this audit technique guide, NAICS #454390 is probably the most appropriate code for direct selling businesses.

*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

#### *Exhibit 1-1 Industry Organizations*

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

### **Income Issues**

#### *Gross Receipts*

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 approximately:

- 44% of their time on selling the product or service,
- 20% of their time on administration and paperwork,
- 15% of their time on recruiting or sponsoring others,

- 10% of their time on either training someone else or receiving training themselves, and
- 9% of their time on miscellaneous other duties.

The above percentages are only estimates. 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.

In order 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.

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:* 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 recruits sponsors two new consultants, they can earn 4% of the sales of those new recruits. Below is a chart comparing the commissions paid by a few well-known companies:

The companies listed below are only examples. For a more complete listing of companies, visit the [Direct Selling Association - Membership Directory](#).

<b>Company</b>	<b>Products</b>	<b>Base Commission</b>	<b>Average Show</b>
Mary Kay	Skin care/cosmetics	50%	\$250.00
Avon	Health/beauty supplies	20%	
Tupperware	Kitchenware	35%	
Party Lite	Candles & accessories	25%	\$400.00
Pampered Chef	Kitchen tools	20%	\$470.00
Longaberger	Baskets & pottery	25%	\$350.00
Home and Garden Party	Home decorations	40%	\$350.00
Creative Memories	Scrap booking	30%	\$300.00
Stampin Up	Rubber stamping	35%	\$300.00
Discovery Toys	Educational toys	25%	\$300.00

In addition to the base commission and the additional commission earned on a down-line, there is an added benefit of personal discounts.

Company	Products	Personal Discount	Members
Mary Kay	Skin care/cosmetics	50%	900,000
Avon	Health/beauty supplies		3.3M
Tupperware	Kitchenware	45%	
Party Lite	Candles & accessories	50%	11,000
Pampered Chef	Kitchen tools	20%	67,000
Longaberger	Baskets & pottery	45%	70,000
Home and Garden Party	Home decorations	40%	30,000
Creative Memories	Scrap booking	30%	50,000
Stampin Up	Rubber stamping	20%	22,000
Discovery Toys	Educational toys	20%	

The personal discounts in the above examples show an average of 36% savings on personal purchases of the products that are offered by the companies. The discounts range from 20% (Pampered Chef) all the way up to 50% (Mary Kay).

All income that is received as a result of direct sales is taxable under IRC Section 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 as a result 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 Section 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 Section 61.

### Form 1099-MISC

IRC Section 6041A(b) and Proposed Regulation Section 1.6041A-1(b) require information reporting on Form 1099-MISC if: (1) 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 similar basis for resale (by the buyer or any other person) in the home or otherwise than in a permanent retail establishment; and (2) the aggregate amount of the sales to such buyer during such calendar year is \$5,000 or more.

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 Section 6041A(b).

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:** *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.*

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.

## **Expense Issues**

### ***Start-Up Expenses***

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.

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.

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?

We need to consider whether expenses are start-up expenditures under IRC Section 195 or inventory and/or cost of goods sold under IRC Section 471. Let’s first consider start-up expenditures.

### ***IRC Section 195***

IRC Section 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.

IRC Section 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 Section 195(b) (1) provides that if a taxpayer makes an election –

- the taxpayer is allowed to 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.

For amounts paid or incurred on or before October 22, 2004, IRC Section 195(b) (1) provided that, if a taxpayer makes an election, start-up expenditures may be treated as deferred expenses and deducted ratably over a period of not less than 60 months, as may be selected by the taxpayer, beginning with the month in which the active trade or business begins.

An election under IRC Section 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.

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 Section 165.

### ***Inventory and Cost of Goods Sold***

Per Treasury Regulation Section 1.471-1, in order 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.

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 Section 162, the expense must be an ordinary and necessary expense paid or incurred in carrying on a trade or business (also see Regulation 1.162-3). Under IRC Section 262, no deduction generally is allowed for personal, living, or family expenses.

***Example 1:*** 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.

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:** *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 an item is discontinued, she either starts using the demonstrator in her own kitchen or tries to sell it. When she had a garage sale, she sold a number of 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.*

## **Partnership v. Sole Proprietorship**

The majority of 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 of his/her assets, whether or not 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.

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 Sections 761(a) and 7701(a) (2) defines the term “partnership” to include a syndicate, group, pool, joint venture, or similar organization carrying on a trade or business 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.

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.

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.

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.

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.

## Employee v. Independent Contractor

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.

A direct seller usually signs up with a particular company to sell its product line. The company may refer to the direct seller by one of the following titles:

- Consultant
- Coordinator
- Dealer
- Demonstrator
- Designer
- Director
- Distributor or direct distributor
- Instructor
- Manager or supervisor
- Representative or sales representative
- Independent business owner

The above list of titles is not all inclusive.

Direct sellers are self-employed. This generally means that they have to 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.

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.

IRC Section 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 for resale by the buyer or any other person in the home or in some other place that does not constitute 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 in some other place that does not constitute 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 service-recipient and the contract provides that such person will not be treated as an employee with respect to such services for federal tax purposes.

According to the Direct Selling Association (DSA), a vast majority (99.9%) of all direct sellers are classified for federal tax purposes as independent contractors. These independent business people are micro-

entrepreneurs whose purpose is to sell the product and/or services of the company they voluntarily choose to represent.

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.

Revenue Ruling 85-63, 1985-1 C.B. 292, holds that an individual who performs services as a direct seller, as defined in IRC Section 3508, is liable for the tax on self-employment income. Proposed Regulations Section 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 person for whom such services are performed shall not be treated as an employer, for federal income and employment tax purposes.

Revenue Ruling 85-63 discusses the following factual situation:

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 section 3508(b) (2) of the Code.

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 section 3508(a) of the Code, B would be Y's employee within the meaning of section 3121(d) (2). Y does not withhold FICA or federal income tax from the remuneration paid to B.

The Revenue Ruling holds that B is liable for the self-employment income taxes imposed by IRC Section 1401.

***Questions to ask on this issue:***

- *Schedule C.* Is the business properly being reported on the Schedule C, with net income being subject to self-employment tax?
- *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?
- *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?

**Profit v. Not-For-Profit Issue**

IRC Section 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 Section 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 Section 262, however, no deduction generally is allowed for personal, living, or family expenses.

IRC Section 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 Section 183(c) to mean any activity, other than one with respect to which deductions are allowable for the taxable year under IRC Section 162 or under paragraphs (1) or (2) of IRC Section 212.

If an activity is not engaged in for profit, IRC Section 183(b) allows a taxpayer the deductions that would be allowable without regard to whether or not the activity is engaged in for profit. If the gross income derived from the activity for the taxable year exceeds these deductions, IRC Section 183(b) also allows a taxpayer to deduct the amounts that would be allowable as deductions if the activity were engaged in for profit, to the extent of any remaining gross income.

Under IRC Section 183(d), an activity is presumed to be engaged in for profit if the gross income derived from the activity exceeds the deductions attributable to the activity for three or more of five consecutive taxable years. This presumption is rebuttable; that is, the IRS may establish that, despite the fact that the gross income exceeded the deductions for the requisite time period; the activity is not engaged in for profit. On the other hand, if the gross income does not exceed the deductions for the requisite time period, there is no presumption that the activity was not engaged in for profit; that is, examiners cannot rely on IRC Section 183 (d) as the basis for disallowing losses.

The test to determine whether a taxpayer conducted an activity for profit is whether they engaged in that activity with an objective of earning a profit. Although a reasonable expectation of profit is not required, the profit objective must be bona fide, as determined from a consideration of all the facts and circumstances.

The regulations under IRC Section 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 exceeds the number indicating the presence of a profit objective (or vice versa) is not conclusive.

Past court cases that have considered whether the taxpayer is engaged in a trade or business and whether an activity is engaged in for profit include:

- Commissioner v. Groetzinger, 480 U.S. 23 (1987)
- Higgins v. Commissioner, 312 U.S. 212 (1941)
- City Bank Farmers Trust Co. v. Helvering, 313 U.S. 121 (1941)
- Owen v. Commissioner, 23 T.C. 377 (1954)
- Haft v. Commissioner, 40 T.C. 2 (1963)
- Schwinn v. Commissioner, 9 B.T.A. 1304 (1928)
- Schott v. Commissioner, T.C. Memo. 1964-272
- Engdahl v. Commissioner, 72 T.C. 659 (1979)
- Boyer v. Commissioner, 69 T.C. 521 (1977)
- Herrick v. Commissioner, 85 T.C. 237 (1985)
- Elizabeth Giles v. Commissioner, T.C. Memo. 2005-28

## **Nine Factors and Analyses**

Using *Minnick v. Commissioner*, T. C. Summary Opinion 2002-147, this section will briefly review how one court evaluated each of the nine factors in deciding whether an activity was engaged in for profit. The taxpayer operated a home-based direct selling business, but the principles involved are generic; that is, they apply in the same way to any business.

**Factor 1** (Manner in Which the Taxpayer Carries On the Activity) – The activities in *Minnick* were not conducted in a sufficiently businesslike manner. Petitioners did not maintain their own business records other than notes of meetings in a daily planner. Petitioners did not present evidence of any formal budgets, profit projections, or break-even analyses that had been prepared in connection with their distributorship. (*Factor favors government.*)

**Analysis:** In addition, the trade or business must be carried on regularly and in a continuous manner to display the intention of a going concern. This intent is noted through the business records, which should include:

- budgets
- books and records
  - indicating active management
- set reasonable goals
  - continuous evaluation of these goals
  - adjust business activities and expenditures based on actual goals

Each person maintains their own books and records in a manner appropriate to their business style. However, any ongoing business needs books and records that give a picture of where the business is going, whether business methods are profitable, and what changes should or can be made to brighten the picture, at least on a quarterly basis. Some of the IRS's concerns are:

- Not maintaining a separate business checking account
- Not maintaining a log tracking business miles driven
- Inability to determine success of business
- Customer/party files not maintained
- Continued expenditures in activities that show little or no profit potential (such as craft shows and exhibitions)
- Bartering transactions that are being done with parties, whether a book party or an in-home party
  - Whenever an individual receives items with a fair market value of \$600 or more in any one calendar year, they are to be issued a Form 1099 for the full amount received. Since direct sellers operate their own business, they are responsible for issuing this form to any host or hostess to whom it applies.

**Factor 2** (The Expertise of the Taxpayer or His Advisors) – In *Minnick*, petitioners sought the advice of persons who might be considered experts in their business activities. Petitioners attended various events conducted regularly that they believed would provide the expertise necessary to make their distributorship profitable. (*Factor favors taxpayer.*)

**Analysis:** A direct seller may not have prior sales training or expertise in direct selling, but that does not negate a profit objective. The examiner should evaluate the direct seller's willingness to learn the business and gain hands-on experience. The more the direct seller knows about the business, the better prepared he is to sell the products and represent them. For direct sellers, the most important source of useful business-building information will often be other successful leaders in their business.

**Factor 3** (Time and Effort Expended by the Taxpayer) – In *Minnick*, petitioners devoted approximately two nights per week, and approximately two weekends per month, to the activity. This time was spent in delivering products and in traveling to other individuals' homes for evening meetings as well as to monthly meetings and quarterly "major functions." (*Factor favors taxpayer.*)

**Analysis:** The fact that a taxpayer carries on employment or more than one business at any given time is not evidence of a lack of a profit motive. How the time is spent is more important than the amount of time spent on the activity.

- Does the direct seller show that the use of their time clearly reflects efficiency and growth in their business, rather than just plugging along and working at it haphazardly?
- Does the direct seller spend time evaluating whether a particular activity that shows very little profit potential should be discarded and a more beneficial activity be picked up?
- Does the direct seller display a desire to recruit downliners, do they increase the number of sales or opportunity presentations as time goes by, are they seeking out opportunities to make themselves more visible in the public eye?

There should be several indicators of a desire to grow a business, rather than working at such a pace that the activity may be considered a hobby rather than a true business.

**Factor 4** (Expectation That Assets Would Appreciate in Value) – This factor is not relevant in *Minnick*. There were no assets subject to significant appreciation.

**Analysis:** The fact that most direct sellers typically have few capital assets should not cause one to question the legitimacy or viability of the business.

**Factor 5** (Taxpayer's Success in Other Activities) – In *Minnick*, no evidence was produced showing that either of petitioners had ever engaged in similar activities, or that either had ever been involved with making other activities profitable. (*Factor favors government.*)

**Analysis:** The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he/she is engaged in the present activity for profit, even though it may not currently be profitable. The fact that the taxpayer has not been engaged in a similar activity in the past does not negate a profit motive in the present activity.

**Factor 6** (Taxpayer's History of Income or Losses) and **Factor 7** (Amount of Occasional Profit, If Any) - A profit objective is strongly indicated where the taxpayer has experienced a series of profitable years. A series of losses incurred during the startup stage of an activity does not necessarily indicate the lack of a profit objective, but it may so indicate if the losses continue beyond the customary startup period and are not otherwise explainable as due to customary business risks. In *Minnick*, the taxpayers sustained substantial losses in their distributorship activities for at least six consecutive years, no profits were ever earned from the activity, and there was no indication that the business would eventually become profitable. (*Factors favor government.*)

**Analysis:** For the Service it is no different for the direct sellers than it is for any other business out there. A direct seller normally goes into business with the hope and intent that their endeavor will become profitable. If, after a suitable start-up period, a business shows no profit or trend toward profitability, it is appropriate for the examiner to evaluate the actions the business owner has taken to become profitable. The examiner should generally expect to see evidence that the seller has adjusted their business in ways that are intended to increase sales, mitigate costs, or both. This requires a very factually specific inquiry and should consider both the seller's long and short range plans and actions. While it should be rare to see a seller stay in business over a long period of time if they do not demonstrate any trend towards profitability, an examiner must also consider the extent to which the seller's early period activities may constitute an investment in the business' long-term viability. It should also be noted that the presumption articulated in Section 183(d) does not stand for a finding that in the absence of the taxpayer realizing at least three profitable years out of five, an activity is prima facie not-for-profit.

If the direct seller is audited in the first or second year after start-up, the direct seller can elect to postpone an IRS determination as to whether the presumption under IRC Section 183(d) applies. The direct seller may file Form 5213, *Election to Postpone Determination*, if an activity has not been carried on for a 5-year period. How does this benefit them? The IRS will generally postpone its determination of whether the activity is engaged in for profit and will not restrict deductions during the 5-year period.

In order to take advantage of this election, the Form 5213 must be filed within 3 years after the due date of the return for the first year of the activity, or, if earlier, within 60 days after the IRS issues a written notice proposing to disallow deductions attributable to the activity. Filing the form automatically extends the period of limitations for tax assessment on any year in the 5-year period until 2 years after the due date of the return for the last year of the period. The period is extended only for deductions attributable to the activity and any deductions that are affected by changes made to adjusted gross income.

**Factor 8** (Financial Status of the Taxpayer) – In *Minnick*, petitioners' separate wage and salary income provided a substantial source of income apart from the distributorship. (*Factor favors government.*)

**Analysis:** While it can be true that the absence of any other substantial source of income may strongly indicate a taxpayer's profit motive, the presence of income from other sources does not, by itself, negate a profit objective.

**Factor 9** (Elements of Personal Pleasure or Recreation) - Profit need not be the only objective, and personal motives may coexist with an actual and honest intent to derive a profit. In *Minnick*, the court found the significance of personal motives difficult to gauge. On the one hand, petitioners expended a substantial amount of time in activities, such as driving long distances that would appear to lack elements of pleasure or recreation. On the other hand, much of petitioners' activities involved elements that were very personal in nature, such as frequently visiting family members who were also involved in the same business. (*Factor determined to be neutral.*)

**Analysis:** The direct seller can enjoy his/her business and receive personal pleasure from it, but still be engaged in it for profit. It should be considered whether any significant recreational or entertainment element was ordinary and necessary to grow the business. (Is the direct seller engaged in the activity for personal pleasure or for the building of a business that will create income? Is the direct seller engaged in the business because he or she likes the product and all the amenities that go along with it?)

The direct sellers' business requires meeting people and carrying on active social interaction—recruiting other sellers and selling to ultimate individual purchasers. Normally, a prudent direct seller organizes various quasi-social environments in which to market its products or connect with 'prospects,' which often involves family, friends, and acquaintances. These business activities should not be discounted on their face if they can be shown to have been appropriate and helpful in developing the business.

The weight of the factors will vary with the taxpayer and with the type of activity. In *Minnick*, the court placed great weight on the manner in which the business was carried on (Factor 1) and the history of losses and lack of profits (Factors 6 and 7) in determining that there was a lack of profit motive.

The type of business activity and the taxpayer will dictate which factors are more important in relation to each other. With respect to direct sellers, Factors 1, 3, 6, and 8 are generally dominant, Factors 2, 5, and 9 less important, and Factor 4 rarely will come into play. Factor 7 (amount of occasional profits) deserves special note and applies in all situations.

More detailed information on examining an IRC 183 Activity Not For Profit issue is available in the [Audit Technique Guide for IRC 183 Activities Not Engaged For Profit](#) which includes extensive information on the nine factors, interview questions, examination techniques, etc.

## **Examination Practices**

We want to ensure in our audits that examiners are not prejudicial when considering whether taxpayers are engaged in any particular industry for profit. Each taxpayer is entitled to be evaluated by a fair, impartial examiner so that a fully reasoned determination can be made.

*What an Examiner Should Not Do* – An examiner should not tell a taxpayer that, because he is involved in a particular business activity, it is not possible to make a profit and his losses are therefore disallowed.

*What an Examiner Should Do* – An examiner should thoroughly interview the taxpayer to gather the factual information to evaluate each of the nine factors outlined above. If it is determined that there is no profit motive and the taxpayer does not agree, the examiner should also consider an alternative position in the event that it is later determined that the taxpayer was engaged in the activity for profit. Expense items of a material nature should be examined. The taxpayer should be informed of the dual nature of our approach.

Fair and consistent treatment of taxpayers is a cornerstone of tax administration. We must always be concerned with the perception by taxpayers of inequitable treatment.

### Websites For More Information:

<b>Direct Selling Company</b>
<a href="#">Mary Kay Cosmetics</a>
<a href="#">Avon</a>
<a href="#">Tupperware Corporation</a>
<a href="#">PartyLite Candles</a>
<a href="#">The Pampered Chef Ltd.</a>
<a href="#">The Longaberger Company</a>
<a href="#">Home and Garden Party</a>
<a href="#">Creative Memories</a>
<a href="#">Stampin Up</a>
<a href="#">Discovery Toys</a>
<a href="#">Amway Corporation</a>
<a href="#">NuSkin</a>

Note that Quixtar, which is the sister company of and successor to Amway in North America, represents a large constituency within the direct selling universe. Examiners are likely to encounter the name more frequently perhaps than some others.

The above is not an all inclusive list of direct selling opportunities. You may also wish to visit the [Direct Selling Association - Membership Directory](#).

### Code Sections, Revenue Rulings and Court Cases

<b>Code Section</b>	<b>Description</b>	<b>Page</b>
IRC § 61	Gross income consists of all income, from all sources, such as compensation for services, business income, interest, rents, dividends and gains from the sale of property. Only items specifically exempt may be excluded. Gross income is the starting point in determining tax liability and is broadly defined.	2-2



<b>Code Section</b>	<b>Description</b>	<b>Page</b>
IRC § 74(a)	Except as otherwise provided in this section or in section 117 (relating to scholarships), gross income includes amounts received as prizes and awards.	2-3
IRC § 162	Specifically focuses on the issue of trade or business expenses	2-10
IRC § 183	In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.	2-10
IRC § 183(d)	If the gross income derived from an activity for 3 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, unless the Secretary establishes to the contrary, such activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit. In the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, the preceding sentence shall be applied by substituting "2" for "3" and "7" for "5".	2-10
IRC § 195	Start-up expenditures may, at the election of the taxpayer, be treated as deferred expenses.	2-4, 2-5
IRC § 212	Defines business activities	2-10
IRC § 262	Addresses the disallowance of personal, living and family expenses	2-6
IRC § 471	Accrual Method	2-4
IRC § 761(a)	Defines partnership	2-7
IRC § 1401	Imposes taxes upon the self-employment income of every individual.	2-10
IRC § 3121(d)(2)	Defines employees	2-9
IRC § 3508(b)(2)	Provides in part that the term "direct seller" includes a person only if such person (i) is engaged in the trade or business of selling (or soliciting the sale of) consumer products to any buyer on a buy-sell basis, a deposit-commission basis, or any 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 (ii) 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.	2-8, 2-9
IRC § 6041A(b)	Requires information reporting on form 1099 MISC	2-3
IRC § 7701(a)(2)	Defines partnerships	2-7

<b>Revenue Rulings</b>	<b>Chapter Section</b>	<b>Page</b>
Rev. Rul. 85-63	Self-employment tax deduction	2-9

<b>Court Cases</b>	<b>Cite</b>	<b>Page</b>
Boyer v. Commissioner,	69 T.C. 521 (1977)	2-11
Commissioner v. Groetzinger	480 U.S. 23 (1987)	2-11
City Bank Farmers Trust Co. v. Helvering	313 U.S.121 (1941)	2-11
Elizabeth Giles v. Commissioner	T.C. Memo. 2005-28	2-11
Engdahl v. Commissioner	72 T.C. 659 (1979)	2-11
Haft v. Commissioner	40 T.C. 2 (1963)	2-11
Herrick v. Commissioner	85 T.C. 237 (1985)	2-11
Higgins v. Commissioner	312 U.S. 212 (1941)	2-11
Minnick v. Commissioner	T.C. Summary Opinion 2002-147	2-11
Owen v. Commissioner	23 T.C. 377 (1954)	2-11
Schott v. Commissioner	T.C. Memo. 1964-272	2-11
Schwinn v. Commissioner	9 B.T.A. 1304 (1928)	2-11

<b>Publication</b>	<b>Topic</b>	<b>Page</b>
Publication 15-A	Employer's Supplement Tax Guide: Wages for the services of an individual who works for his or her spouse in a trade or business are subject to income tax withholding and social security and Medicare, but not to FUTA tax	2-9

# ***Auto Body/Repair***

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## **Introduction**

### ***Overview***

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.

A body shop is also regulated by environmental agencies. 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 which are used in spray form. Because violations of air quality regulations can bring stiff penalties, these regulations are often closely adhered to.

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

### ***Repair/Replacement***

A distinction should be made 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 body work 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 body work.

With the advent of unibody construction, the repair process has been made even more complex. In the older domestic vehicles, components were bolted to a frame which acted as the support for vehicle road shock. In unibody construction, the components act as the frame. If a unibody vehicle has been damaged, simply replacing the component may not be enough to restore the vehicle. Other components must be checked to determine if they have been shifted from the original positions.

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.

### ***Paint Process***

Once the vehicle has been repaired it will be painted 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, a clear coat is applied to give the paint a shiny or metallic look.

### ***Other Processes***

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. Major mechanical work is usually sublet out to an auto repair shop.

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.

### ***Estimation Process***

An examiner should be familiar with the estimating process since gross income is based on this Concept. An estimate is used to provide the customer with the final cost or as an agreement between the shop and the insurance company as to how much will be paid for the job.

The estimate may be prepared by the body shop, the insurance company, or an independent appraisal company. 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 particular 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

If an estimate has been prepared by the auto body shop, it must still be approved by the insurance company which is paying the claim. 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.

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

#### Body Shops

- Auto body work is mostly reimbursed by insurance companies.
- Body shops buy parts primarily from dealerships.
- Body shops generally buy what is needed for a specific job but may stock some paint materials and small supplies.
- Body shops see their customers far less often.
- Body shops usually use estimate forms with their repair orders.
- Body shops generally charge a different rate for metal, paint, and frame labor.
- Body shops sometimes pay all or portion of their staff on a based percentage of labor billings.
- Body shops generally have work- in-process but little parts, materials and supplies inventory

#### Repair Shops

- Repair shops have some insurance work but most of the costs are paid by the owner of the vehicle.
- Repair shops 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.
- Repair shops often order common parts in bulk as well as lubricants and fluids.
- Repair shops are likely to have a steady clientele and a lot of repeat and family business.
- Repair shops may not use the estimate forms seen in a body shop.
- Repair shops may charge a flat rate for mechanical labor which is usually billed at a higher rate.
- Repair shops usually pay an hourly wage.

- Repair shops usually have less work-in-process and stock parts, materials, and supplies.

## Initial Interview

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.

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.

Questions about the accounting records should be directed to the bookkeeper, controller, secretary, or accountant unless the principals are involved directly 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.

The acquisition of substantial new machinery and equipment might suggest a shift in operations. A number of 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.

Some questions to incorporate into your auto body/repair interview follow below. The listing includes only items relating to the repair process, sales, and officer/shareholder duties. Questions about the business history, accounting methods, internal controls, and mandatory items should, of course, be added:

- When are initial estimates made? Is any charge made for them?
- 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 it 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 it thrown away or retained? How many are voided?
- Do some repair orders require supplements? Is a new repair order written for the supplement? When will the supplement be paid for? Is the vehicle released prior to the receipt of the supplement? When will the 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? (will vary with make of vehicle)
- What are the labor rates charged for repair (will vary 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. 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 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? (that is as a lessor, vendor, consultant)
- Does the corporation own or lease vehicles assigned for the use of specific officer/shareholders?

## **Tour of Business**

A typical auto body shop will usually have a parking area where estimates are made, for 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.

If the Auto Body Shop has not shown any inventory on the return, are there parts lying around the premises waiting to be installed? Does the storage area for paint hold cans of paint? 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 and which appears to be no longer in use.

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 actually working on the premises of the Auto Body Shop?

Take a 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 actually sub-leasing it to a third party. A review of the lease agreements at a later date should show the addresses under lease. This should show up as other income or a credit to rent expense.

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.

## **Books and Records**

### ***General Books and Records***

Distinctive journal encountered fairly consistently was the sales journal which 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 Charges
- Storage Charges
- Sales Taxes

### **Specific Documents**

In performing an effective audit, it has been noted 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 office handling the claim.

- Date of Estimate - This date may be important in determining when the vehicle was actually 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 also 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. The following items may be listed:
  - 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. Vendors and invoice numbers may also be listed. In some cases, the net price (wholesale) and the list price (retail) may be listed.
  - 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 check number, the date the check was received and the amount of the check. This information is often needed to determine when the sale should be recorded.
- 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 that are incurred after the original estimate was approved. Supplements should have the following information:
  - Customer Name and the Date supplement was either written up or approved,
  - Vehicle description,
  - Insurance Company authorization.
  - In some cases where the body shop has a good relationship with the insurance adjusters, only the shop owner's signature is required.

It should be noted that supplements are generally paid by a different check from the original insurance payment. 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.

### ***The Mitchell Guides***

The Mitchell Guides and Mitchell Software provide information which 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.

The Guides are a series of volumes which 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 are updated several times each year depending upon pricing changes.

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.

Mitchell also supplies the suggested labor time (in tenths of an hour) it will take to **replace** a particular part. These times will be broken down into the complexity of the labor involved (that is, body, frame, paint etc.). Labor times will also be provided for replacement of glass, application of stripes and decals, and for things such as sanding and grinding.

### ***Organization of Records***

It is important to identify how the records are organized since the nature of the examiner's request will depend on the method used:

- **Current Jobs:** Auto Body shops usually maintain current jobs in folders (job jackets). The information contained will include the estimates for that particular 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.
- Usually the above information is kept together in one package by customer. This allows the shop to answer most questions which may arise once the job has been completed.
- Sometimes the Auto Body Shops will separate the invoices by vendors. This is especially true where shops have established a credit line allowing all invoices accumulated in one month to be paid off at one time.
- In smaller body shops it is not unusual for all information to be accumulated by the month. Invoices paid and sales collected in a single month will be filed together in an envelope.

## **Income**

### ***Introduction***

The repair process in a 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.

If the owner of the vehicle is to bear the full expense of the repair and chooses to deal with the shop, a repair order is written 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 to be done.



If there is an insurer, the company is notified and dispatches 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 may be considered less than the sum of the times needed to paint each section alone. Further reduction can be 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.

The cost of new auto body parts and the suggested installation time are listed in the Mitchell Manual, 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 leads 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 and the areas of alteration from the initial offer are noted below the chart.

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, however, as was done by the insured to obtain the settlement charted. Once the insurance company has approved an estimate, work on the job can proceed and a repair order is generated echoing the approved amounts. Approval by the insurance company fixes the amount that will be paid by them 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.

Some shops openly advertise that they will "save your deductible" and others will offer the option if pressed, or at least offer some concession. This is generally accomplished by repairing versus replacing or by installing used or after market parts instead of factory replacements. 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 fairly common, opens a door to considerable abuse in reporting income when a deductible is shown as waived in the accounting records, but was actually collected.

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 sections are removed. Parts prices may also have increased since the last issued Mitchell Manual. When this occurs, the customer or his or her insurance company must be notified and approval to perform additional repairs secured. If an insurance company is involved, an adjuster may again be sent out to inspect the damage, or approval may be given over the phone, particularly in the case of price increases. In either case, a second supplemental payment will be issued by the insurer and receipt of this payment may be delayed some 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 only an addendum is made to the existing file.

**Auto Body Shops example of expenses illustrating the differences possible between shops and Insurer**

<b>Parts Expenses:</b>	<b>Shop 1</b>	<b>Shop 2</b>	<b>Shop 3</b>	<b>Insurer</b>
<b>Front Lamps Assembly</b>	\$61.73	\$61.73	\$81.82	\$61.73
<b>front Fender</b>	\$159.17	\$159.17	\$150.60	\$159.17
<b>Front bumper cover</b>	\$32.43		\$30.68	\$32.43
<b>Splash Shield</b>	\$29.95			\$33.85
<b>Moulding - protective</b>			\$22.98	
<b>Front bumper cover</b>			\$219.05	\$231.53
<b>Parts Totals:</b>	\$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>Labor:</b>				
<b>Sheet Metal Expenses</b>				
<b>Hours</b>	8.1	15.3	17.0	8.0
<b>Rate</b>	\$28.00	\$28.00	\$28.00	\$26.00
<b>Sheet Metal Total</b>	\$226.80	\$428.40	\$476.00	\$208.00
<b>Labor:</b>				
<b>Refinish (paint) Expenses:</b>				
<b>Hours</b>	4.4	12.3	11.0	5.9
<b>Rate</b>	\$28.00	\$28.00	\$28.00	\$26.00
<b>Refinish Total</b>	\$123.20	\$221.40	\$198.00	\$153.40
<b>Labor:</b>				
<b>Mechanic (frame) Expenses:</b>				
<b>Hours</b>	0.0	1.5	1.0	1.0
<b>Rate</b>	\$-	\$45.00	\$45.00	\$35.00
<b>Mechanic Total</b>	\$-	\$67.50	\$45.00	\$35.00
<b>Labor:</b>				
<b>Sublet Expenses:</b>				
<b>Paint Materials</b>	\$79.20			\$88.00
<b>Cover Car</b>	\$10.00	\$10.00		\$10.00
<b>Wheel Alignment</b>	\$65.00			
<b>Undercoat</b>	\$8.00			
<b>Wash &amp; Wax</b>		\$25.00		
<b>Hazardous Waste Fees</b>			\$26.80	
<b>Sublet Totals</b>	\$162.20	\$35.00	\$26.80	\$98.00
<b>Total of all expenses:</b>				
	<b>Shop 1</b>	<b>Shop 2</b>	<b>Shop 3</b>	<b>Insurer</b>
<b>Parts Totals:</b>	\$283.28	\$220.90	\$505.13	\$518.71
<b>Labor Totals:</b>	\$512.20	\$752.30	\$745.80	\$494.40
<b>Sales Tax:</b>	\$31.39	\$36.49	\$45.70	\$50.92
<b>Total of all costs:</b>	\$826.87	\$1,009.69	\$1,296.63	\$1,064.03

## Categories of Charges

### *Parts and Materials*

Parts include any replacement to a vehicle component done by the shop. For a body shop, that usually means metal sections, 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. The costs should be separately shown on an estimate and segregated on a repair order.

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.

### ***Labor***

Labor is usually broken down by category in a body shop since rates differ for each category of service. The distinction is usually made 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. Mechanical labor in repair shops is generally billed at a flat hourly rate for all services without the distinctions made in body shops even though the skill level required to perform different tasks varies.

### ***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 are sublet by body shops. Repair shops sublet the preceding, except mechanical work, and most body and paint work.

### ***Towing***

Towing is occasionally included in sublet accounts but usually listed separately. Tow charges needed to deliver the vehicle to the repair shop and billed to the facility are rebilled to the customer at cost or with a small markup. 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 section of this guide.

### ***Storage***

While not usually a major source of income, all body shops will have some income from storage fees. Charges vary, but can be levied at \$20 to \$25 a day and arise when 1) a car towed in for repair is totaled out but the insurance company does not promptly assess and remove the vehicle 2) a car is left for an estimate and the owner declines to authorize repair or remove the vehicle and 3) 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 a grace period, usually 3 days, is allowed before fees are billed.

### ***Vehicle Sales***

Shops occasionally repair and resell damaged vehicles purchased from individuals, salvage yards, and auctions. Vehicles left for repair or estimate that have not been claimed are subject to lien sale. The cost of filing ranges from \$45 to \$70 through a company providing this service, depending on the value of the vehicle, and can be recovered from the customer redeeming the vehicle prior to auction. Lien sale filings can also be made directly through the State Department of Motor Vehicles. It is unusual to find more than a handful of lien sales filed in the course of a year at a shop

## **Other Income Sources**

### ***Rebates and Refunds of Expense***

Car rental agencies may rebate a portion of the fees paid by the repair or body shop or customers referred by them.

Insurance dividends and cancellation adjustments may be treated as an expense account reduction but may be reported as miscellaneous income, especially if applicable to a prior period expense.

Vendors issue checks for merchandise returns when the shop does not maintain an account. In some cases, refund check is issued for larger items even if a credit line is maintained. These refunds may be reported as a credit to the expense account rather than income.

### ***Supplemental Payments:***

The Auto Body Shop may record their sales based on the final repair orders which listed the income to be received 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 when the supplemental payments were received. 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 why the supplemental payments were not recorded with the original repair order. The Auto Body Shop may respond that supplemental payments were not assured of being paid. However, in many case, the supplemental payments were almost 100 percent guaranteed of being paid especially if an insurance companies 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.

### ***Other Sources***

Repair shops may also sell gasoline or issue smog certificates. The number of certificates issued to any location should be traced.

## **Indications of Underreporting**

### ***Estimating Sales***

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.

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 put you in the ball park.

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. An average can be obtained by inspecting the detail invoices from the suppliers used and repair orders.

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 changed to 40 percent when the status was changed to that of employee. Double labor costs to initially estimate labor income. If the owner works on the vehicles, the value of his or her labor should be added to 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 actually reported is outside of this range, find out why. One reason is underreported income, but there are others, some of which are:

- The above percentages are invalid for this particular business, especially for labor.
- Costs have been mis-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.

Once the examination is under way, the direct expenses can be categorized and the above percentages refined 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.

### ***Repair Orders***

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 of 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. Some of the skipped numbers may be accounted for by voided orders, if they have not been 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 can't show how much is not reported, but unexplained missing repair orders may account for the difference between the estimate of expected income and the amount reported.

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.

### **Other Income Issues**

#### ***Waived Deductibles***

As stated earlier, saving or waiving a deductible in whole or part, in order to attract business is not uncommon among auto body shops. This is usually 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 into the sales journal at net, or the waived portion may be accounted for as customer allowances or concessions.

An insured collision repair is payable in two parts, the insurance company's check or draft and the insured's deductible payment. If the copayment is fully waived, the insurance payment is considered as payment in full and either method of accounting for the income outlined is an accurate representation. If, on the other hand, the repair cost is fully paid in the usual manner and the deductible is shown waived on the accounting records only, considerable income can be unreported.

If deductibles are routinely shown waived and you suspect that they have actually been collected, third party contact with some of the customers is facilitated by the phone numbers customarily included on all repair orders.

#### ***Cash Payments***

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 was often delayed. Many body shops insist on payment by a certified or cashiers check or cash.

## Cost of Sales

### *Introduction*

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 which are:

- Purchases
- Labor
- Sublet Expenses
- It may also include inventory totals for the beginning and ending of the year.

### *Purchases*

The major cost associated with the purchases account will be for parts used in the replacement or repair process. These can be purchased new from auto dealers or parts stores, or may be purchased used from auto dismantling businesses. In some cases, entire automobiles may be purchased 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 once the parts have been replaced or repaired. This category includes bond, primers, thinners, paints, sandpaper, etc. These will usually be purchased from businesses which specialize in automotive paints. Since the majority of jobs are paid for by insurance companies, the amount the auto body shop will eventually receive for the repair of a vehicle will be determined before the job is actually started. 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 can usually be delivered in a matter of days or even hours. However, in some cases, parts need to be ordered directly from overseas factories which can result in delays of several weeks or even months. If a part is no longer manufactured, the auto body shop may have to search the various dismantling businesses to find one. Some fabricate parts for high end or classic vehicles.

Records to Request/Examine:

- 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 the estimate has been approved, the 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 which may prove useful is that these invoices will often list the model and year of the vehicle which is associated with the parts purchased.

#### Purchases Audit Procedures

Auto Body Shop's method of filing their records may require modification of the examiner's transaction selection process. Because these situations may arise, they are mentioned here:

- 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 may comprise a single transaction in the general ledger may be separated if pertaining to several customers. If this type of arrangement is encountered, the transaction selection process may need to be made from the sales journals in conjunction with the income test work. It should be noted however, that this type of arrangement makes the inventory test work easier.
- 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, repair orders and estimates may still be filed by customers. In contrast to the preceding situation, inventory test work is more difficult.
- Source documentation filed by month. This situation is commonly encountered with smaller businesses. The estimates, repair orders, vendor invoices, and sales invoices are all filed by the month that the transaction was paid or that monies were received. It should be noted that in order to test the accruals, the subsequent year's first month documentation will need to be requested.

#### *Labor*

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 proceed quite quickly with very few hours or even segments of an hour. However, if the frame of the vehicle has been damaged then the amount of labor involved can escalate. Usually labor is broken down into several primary categories. Labor personnel can be paid either by the hour or on commission. The commission may be a percentage of the allowable amount determined by the insurance companies.

#### Metal Labor

Metal work usually involves the process of replacement or the repair of a part if possible by either straightening or pounding or a combination of both.

#### Frame Labor

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.

#### Paint Labor

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.

#### Minor Mechanical Repairs

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

#### Audit Procedures

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. The actual determination of whether individuals are employees or independent contractors should be discussed with your Employment tax specialist. The examiner should be aware of certain signs which may indicate an employment tax issue.

- 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 make the assumption that all wages are subject to FICA but no more than one-half subject to unemployment taxes.
- Package Audit Steps - This includes a reconciliation of the wages per the books to the employment tax returns. This reconciliation is recommended since this may highlight labor deductions which 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 moved locations. This was highlighted by a sudden jump in wages and employment taxes. The reverse may also be true.
- 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 that straight disbursements without withholding have been made.
- 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.
- 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 representing the Auto Body Shop. Then check the employment tax records to see how they are being treated.

#### *Sublet Expenses*

Sublet expenses are those costs incurred for services and supplies which 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.

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.

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.

## **Expenses**

### ***Uniforms***

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 the number of persons working on the premises may be inferred. 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.

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

For example, the ending balance for a 2006 year listed the balance as \$190,000. The beginning balance for the 2007 year listed the amount as \$30,000, a decrease of \$160,000. The examiner determined that this decrease was due to three classic automobiles held for investment being taken off the corporate balance sheet and transferred to the shareholder. The assets were taken off because the company was in the process of being sold and the shareholder wanted the assets for his personal investment. Corporate costs were involved in the restoration of the classic automobiles.

### ***Non-cleared Checks***

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 which for some reason were never cashed or deposited by the payee.

### ***Other Receivables***

An examination of the employee advances account may reveal that these advances were cleared out by the corporation 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 was never accounted for as far as employment taxes and Form W-2 wages were concerned. Sometimes employee advances are simply transferred to salaries and wages, and again, never accounted for on the employment tax returns.

### ***Automobile Rental***

Rebates on auto rentals are one practice an examiner may see at body shops and, to a lesser degree, repair shops. For example, payment was 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 fairly nominal.

### ***Finders or Referral Fees***

These are called "bird dog" fees and are paid to individuals by body shops for referring customers to the shop. This is illegal in some states and not allowed under the Insurance Code if the individual receiving the payment is an independent adjuster, insurance agent, or broker. The finder's fees ranging from \$50 to \$500 per vehicle that can be paid to a cadre of individuals that may include insurance agents and adjusters. The fees tend to mount up over the course of a year and sometimes no Forms 1099 are filed. Both the Form 1099 penalties and backup withholding are appropriate in such a case.

### ***Lien Sale Filings***

Notice of lien sales can be filed when work has been done or storage charges incurred at a repair or body shop or a towing service, and the vehicle has not been retrieved and the charges paid. Notice is given to the owner prior to lien sale and he or she may redeem his or her property by satisfying the debt plus filing costs.

A lien sale service is generally employed to process the paperwork for a usual charge of \$45 or \$75 depending on whether the value of the vehicle is under or over \$1,000. Recovery Income would be anything over the amount charged.

### ***Towing Service Payments***

Tow truck operators may be paid to deliver wrecked vehicles to a particular body shop. This payment is made in addition to normal towing charges and need not be made directly. For example, the payment may 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.

### ***Insurance Fraud***

Insurance and consumer fraud receive a great deal of media attention. If the Body Shop being examined reports an extremely high profit margin on parts, but the inspection of the purchase invoices from its suppliers indicated 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.

### ***Smog Certificate Sales***

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.

## **Glossary**

**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.

**"After Market" Parts** - Discount parts which are 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.

**Betterment** - Term used to describe additional benefit which may accrue to the party whose vehicle is being repaired. For instance, a tire may need to be replaced. 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.

**Blending** - Process whereby paint is gradually lightened or darkened on a repair vehicle to eliminate spottiness.

**Bondo** - Compound applied to the vehicle to smooth out and fill the exterior so that paint may be applied.

**Claimants** - Term used to describe third party responsible for handling the damage payments. For instance, individual A's vehicle was damaged by individual B. If individual B's insurance company is responsible for the payments to the auto body shop, then individual B would be the claimant. In other situations, the term "claimant" may also be used to describe the individual making the claim.

**Clear Coat** - Finish added after paint job to give the vehicle a high luster look and protection.

**Criteria Sheet** - Agreement form between body shop and insurance company. Items listed will be use of "after market" parts, overlap systems, etc.

**Deductible** - The portion of the repair cost for which the customer is personally responsible.

**Detailing** - After body repair the vehicle may be enhanced by washing, waxing, interior cleaning, shampoo treatments, etc.

**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.

**Drive in Claim Center** - Concept where the customer drives their vehicle to the insurance company to have an estimate performed.

**Estimate** - Process whereby the insurance company or the auto body shops project the cost of the parts, labor, and other supplies needed to repair a vehicle. These projections are based on previous studies done under optimum conditions.

**EZ Liner** - Trade name of the most common type of frame straightener. This is actually a workbench to which the vehicle is attached. Certain points are lined up on the frame and the vehicle is then "pulled" until the frame is straight.

**Flag Sheet** - Sheet used by auto body employees to record the number of hours spent on a specific vehicle.

**Frame** - The structural component of the vehicle to which the body components are bolted or attached. This differs from unibody construction in that the components are attached to the frame rather than the components acting as a frame.

**Hidden Damage** - Additional damage which was not discovered during the teardown and not approved in original repair order. Usually found during later stages of repair. Must be approved for repair separately.

**Insured** - Term used to describe the individual whose vehicle was damaged. The individual's insurance company would be responsible for submitting the final payment to the auto body shop.

**Job Jackets** - Folders used to keep paperwork together for current and on-going jobs.

**Mask** - Bumper Cover.

**Masking** - Protection of glass, chrome, and other parts when the vehicle is being painted.

**Mechanics Lien** - A filing with the Department of Motor Vehicles on vehicles with unpaid charges for repairs and/or storage. If the delinquent amounts are not settled within legally prescribed periods the vehicle can be sold in satisfaction of the debt.

**Mitchell Manuals** - Set of guides which contain the suggested retail and wholesale prices for parts and the suggested labor and paint hours needed to install and paint the various parts. May be in book form or computer software.

**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 section 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. The time to remove part B and part C will be reduced by 2 hours because theoretically, the section needed to be removed to work on the parts only needs to be done once.

**Overspray** - The spray or mist of paint or primer that settles on parts of the vehicle other than those intended to be sprayed.

**Panels** - General term to describe body components. May be described as side panels, quarter panels, etc.

**Pin Striping** - Specialized painting or decaling.

**Primers** - Chemicals used to coat the metal surface of the vehicle to avoid rust and to fill in scratches.

**Repair Order** - Document which usually contains the charges for parts, labor, and other costs. This is approved by the customer before actual work is performed on the vehicle.

**Replacement Repair** - In cases where a body part is completely mangled it will need to be replaced. Frame work is considered repair work. Replacement work costs can generally be obtained from the various pricing guides. Repair work costs may be negotiated between the shop and insurance company or customer.

**Restoration** - Process used for classic, expensive, and antique automobiles whereby the vehicle is restored to its original condition or even better. Involves high quality paint jobs, major engine and transmission replacement, and body parts fabrication.

**Shroud** - Cover for many parts - for example, radiator shroud.

**Skin** -That is "door skin." Refers to the visible metal covering a constructed component.

**Sublet Expenses** - Generic term used to describe services not ordinarily performed by the autobody shop. Includes services like upholstery work, radiator repair, tire replacement, etc.

**Supplemental Payments** - Payments issued by insurance companies which account for additional damage which may not have been spotted during the initial estimate. May also cover price increases of parts not yet updated in the Mitchell Guides. Usually separately issued after regular payment.

**Tear Down** -Removal of surface damage to assess total repair needed.

**Undercoat** - Coating given to the bottom of the vehicle to protect from rust and corrosion.

**Unibody Construction** -Concept where the body parts act as the frame of the vehicle. The parts actually support the weight of the vehicle. The parts are actually bonded together rather than bolted.

**Warranty Work** - Additional work performed after the job has been completed and paid for. In this situation, the autobody shop is responsible for the additional costs.

**Wetblocking** - Sanding done after primer is applied so that paint can be applied.

# Chapter 4: Examination Techniques for the Food and Beverages Industries

## *Retail Liquor Stores*

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### Introduction

The basic merchandise carried by liquor stores is wine, liquor, and beer. The stores usually carry some, if not all, of the following: cigarettes, soda, chips, drink mixes, cheeses, and spring water. Many upscale stores have extensive wine departments with a wine expert on hand. Some small liquor stores are more of a grocery store than a traditional package store.

### Income

The following are some sources of receipts commonly seen in liquor stores:

- *Other grocery sales – lottery, cigarettes, snacks, food & candy items*  
These sales are taxable to the state taxing agency for sales tax purposes. The examiner can compare the reported gross receipts to those reported to the appropriate state sales tax returns. In many instances the states examine liquor stores more frequently than the Internal Revenue Service can, so it is prudent to ask for all recent audit reports, and if necessary, contact the state agency for further information.

Stores with cash registers are required to maintain the daily cash register tapes and present them for examination. If the examiner questions whether all sales are reported, or if the tapes are missing, an indirect method should be considered.

- *Lottery- scratch-off and machine sales*  
Income from lottery sales will be rung on the business cash register and included in total daily receipts. Income from scratch-off tickets is the sole income of the retailer, so the examiner can verify the amount purchased from the third party and calculate appropriate sales. Income from machine tickets can be determined from the monthly reports made by the state that administers the program.
- *Check cashing and customers payment on account*  
Retail stores do not cash checks as a courtesy; they are in business to earn a profit. Checks written for more than the amount of purchase may be accepted for regular customers and a fee may or may not be assessed in this situation. However, when checks such as government welfare benefits or local company payroll checks are cashed, the retailer customarily charges between 3-5% of the check amount, even when a purchase is made. Some state laws dictate a maximum percent/amount that can be charged.

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 sells or grants licenses based on different criteria. The manufacturer may or may not be located in the state. Each state controls what products may be brought inside its borders. The distributor or wholesaler sells and distributes the products to the retailers.

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.

## Cost of Goods Sold

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, but the examiner should contact third-party suppliers directly to ensure cost of goods sold is not underreported.

## Statistics

Current Bizstats.com shows that 68% of food and drinking sole proprietorships report a net profit. For more detail see the [Biz Stats.com Industry Profitability - Sole Proprietorships](#) webpage.

Bizstats.com shows averages for this industry:

Total Expenses as a % of Income:	89.1%
Net income as % of Income:	10.9%
Cost of Goods Sold:	42.5%
Salaries and Wages:	15.4%

# Mobile Food Vendors

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## Introduction

Mobile food vendors can be observed on many street corners, outside warehouse stores, courthouses or any high volume industrial center. They appear to operate strictly in cash and have no forms of internal controls, so the potential for unreported income is great.

There are two types of catering trucks: hot trucks, such as Mobile Food Preparation Vehicles (MFPV), which allow food to be prepared as customers order; and cold trucks, such as Industrial Catering Vehicles (ICV), which sell only prepackaged foods. The hot trucks have at least a driver (which is usually the taxpayer), and a cook, who may be a family member. The cold trucks only need a driver in most instances, since it is a self-service vehicle; however, they are not limited to just the driver.

## Income

This type of business will be largely cash intensive, since most individuals purchasing items from a mobile vendor pay in cash. Accordingly, gross receipts will be the main focus for the examination. The examiner will expect to 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.

If bank deposits are used by the taxpayer to determine gross receipts or by the examiner to test gross receipts, care must be taken to make sure any cash paid out for business *and* personal expenses is added back to the analysis.

Estimating gross income of mobile food vendors can be accomplished with the investment of relatively few examination hours, and can result in a very accurate estimate of the gross income actually earned from the operation. If an indirect method is necessary, the examiner must obtain sufficient testimony from the taxpayer in the interview to evaluate the credibility of the testimony and to corroborate the calculations. Additionally, the examiner and taxpayer must be able to verify the cost of goods sold with some reliability.

The markup is generally consistent for most products sold by mobile vendors, so the percentage on cost of goods sold can be calculated as follows:

Total Sales - Cost of Goods Sold ÷ Cost of Goods Sold = Markup Percentage

Then, Cost of Goods Sold \* 100 + Markup = Gross Receipts appropriately marked up for Sale.

## Cost of Goods Sold

Inventories are seldom reported and may not be material in nature, since food must be sold or discarded soon after purchase and there is usually no space to maintain additional stores.

Expenses may often be paid in cash, so the examiner must ensure that all cost of goods sold are included. This is especially important if income will be estimated, since additional cost of goods sold using a markup percentage of 100-200% will produce substantial gross receipts.

Some driver/owners of food trucks are linked to specific commissaries that stock and store their trucks overnight. The commissary is a wholesale supermarket where the drivers are able to 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.



## Expenses

The examiner may encounter the following types of expenses:

*Vehicle Expense* - There is little question that some transportation expenses are incurred by most mobile vendors. Both food and supply items are often picked up by the vendors, rather than being shipped or delivered. The examiner should be alert for overstated business miles without any consideration for commuting.

In some areas mobile vendors use the services of “strickers” to wash and load trucks. These “strickers” work at the large catering wholesalers and are usually paid in cash. As always, 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 would be difficult for the taxpayer to prove a bona fide business expense exists, since he did not treat it in a business-like manner. It would be equally difficult to prove an expense was paid, especially if it was allegedly paid in cash.

*Penalties, Fines, Tickets* - The examiner should be cognizant of possible violations of the health code, which may be 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 the heating device, would be a deductible business expense. Fines, penalties or tickets are not deductible.

## Glossary

***Cold Truck*** Catering trucks which sell pre-packaged food such as cold sandwiches, for example, self-service industrial catering vehicle.

***Commissary*** Wholesale supermarket where catering truck drivers purchase food in bulk.

***Fleet Operator*** Person(s) who own a number of catering trucks and hire individuals to drive their trucks.

***Food Sales*** An industry which is designed to manufacture or purchase food products for sale to wholesalers or the public.

***Hot Trucks*** Catering trucks which prepare and serve hot food such as full breakfast, hamburgers, burritos, tacos, etc., for example, mobile food preparation unit.

## ***Pizza Restaurants***

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### **Income**

Income considerations will be similar to any other retail operation and will be determined by the internal controls in place. As with any retail business or operation that is cash intensive or where family members can remove currency from the register before sales are recorded, the examination must focus on income and internal controls.

The examiner should be alert for other sources of income, such as delivery sales, faxed orders, internet orders and take-out business. It would be easy to exclude the gross receipts from an entire type of sales. The examiner should question the taxpayer regarding the policy of accounting for each type of sales.

In many smaller and family owned pizza restaurants, documentation of income and expenses may be lacking. In all cases, the cash register tapes must be retained and income must be deposited intact. There must be sufficient documentation to verify the gross receipts reported on the tax return. If income records are unreliable the examiner will use the appropriate indirect method to estimate income.

One such method is the unit volume markup method. It may be necessary to contact the pizza restaurant suppliers to obtain the original purchase invoices on all identified cases. The ingredients purchased and used in the making of pizzas and grinders are used to determine total pizza and grinder sales.

### **Cost of Goods Sold**

As with any restaurant, the examiner should obtain a copy of the menu and review the prices of all menu items with the taxpayer to identify the best selling items and determine the cost of the ingredients.

Purchases may be paid in cash so the examiner should note the extent of cash payments. If purchase invoices are not available third-party contacts can be made, after notifying the taxpayer, to secure an accurate cost of goods sold. As with other restaurants, if cost of goods sold is understated by the examiner then an indirect method for determining income will also understate gross receipts.

The number of pizza boxes used will be a factor in any markup calculation, so the examiner must accurately establish this element of cost of goods sold. It will be necessary to know the number of pizzas that can be made from 100 pounds of flour, since flour deliveries are fairly standard orders in this business. The owner will know exactly how much flour is needed to make the dough for the day-to-day pizza orders.

### **Expenses**

When employees and suppliers are paid in cash, ensure that employment and information returns were filed. In the absence of proper reporting, the taxpayer will have a difficult time proving the expense is actually a bona fide business expense.

## ***Restaurants and Bars***

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### **Introduction**

Restaurants can be *full service* food operations, where one is seated and orders from a wait person, paying at the end of the meal, with an average check of \$15 and above. Restaurants can be *limited service* food operations, such as fast food or casual dining, where one orders, pays for, and picks up their own food and may clear their own table, with an average check of less than \$10. Both types may offer take out food or may deliver food.

Both full service and limited service restaurants may be chains, which simply mean there are more restaurants like it in other locations.

Both full service and limited service restaurants may be franchises, which means an owner has purchased a license (called a franchise) to sell a restaurant's food and use its brand, logos, and name.

But one fact that is consistent is that all restaurants have numerous sales transactions with small dollar amounts, taking place in a short time frame, such as during lunch or dinner. Many restaurants, especially smaller or closely held ones, are cash intensive and employees and/or owners handle large volumes of cash transactions every day.

For this reason, it is important to evaluate internal controls. When a sole proprietor counts cash at the end of the day, records all entries in the sales journal and makes the bank deposits, there is a possibility not all cash is reported and deposited. This can also be true when the same person takes the order, fills the order, receives the payment, records the payment and may even balance the cash register at the end of the day.

Restaurants have a high rate of turnover of employees who often have access to the inventories as well as the cash. As such, there is a potential risk of employee theft and embezzlement unless the restaurant implements and maintains a set of good internal controls.

Conversely, there are restaurants that have proper accounting systems, a good system of internal controls, and owners who report all transactions. These tend to be successful and profitable businesses, partly because once a system is designed that truthfully accounts for every transaction, owners have the information supplied to them from the accounting system and make accurate and wise management decisions.

The challenge for the examiner is to separate restaurant owners who are in compliance with the tax laws from restaurant owners who have failed to satisfy their tax obligations. To do this, the examiner should focus on:

- internal controls
- unreported income by the restaurant,
- cost of sales, and
- Unreported tip income by the employees.

### **Income**

Restaurants and Bars usually have a large volume of transactions each day, they allow employees to handle cash sales and cash tips, and they receive significant cash receipts in a small period of time. For these reasons, the examiner will need to *assess internal controls* and adequately *probe for possible unreported income*.

The examiner should have the taxpayer explain how the entire customer process, from the food order to paying the check, gets recorded in the books, by whom and where. Since there will be a large volume of anonymous transactions it will be difficult to trace specific items to receipts. Instead, trace the process and test amounts:

- Examine the customer checks for a sample shift, for example the 6:00 a.m. to 2:00 p.m. shift for a breakfast diner. Total the customer checks and determine where the income is initially recorded. It may be entered into a cash register and recorded on the tape, or it may be stored in a cash drawer and counted at the end of the shift.
- Count the number of checks the servers turned in for the shift. This is the number of customers that each server waited on during their shift. Is the amount consistent with the taxpayer's initial interview statements?
- (Also, make a note of the items sold. Later, when you examine COGS, see if those items are replenished within a day or two. This could lead to the discovery that items not reported as sold, are continually being replenished.
- This may be a source of underreported income or overstated COGS.)
- Total the checks turned in by each server and match their entry to accounting records, such as daily sheets. Trace this amount to the monthly records and verify with the amount reported in the Statement of Profits and Losses.
- Note the ratio of cash, check, debit card and credit card payments by customers. Is this consistent with the taxpayer's initial interview statements? Is it appropriate for the business? Is the customer payment method consistent with the examiner's observations?
- Determine how cash is stored, used and/or deposited? Many times the full amount of cash is not deposited. A set amount of cash may be retained to be used as change or to pay vendors. For your sample day, if the cash received is not the amount deposited, have the taxpayer explain how the cash was used. Even though the gross receipts should be determined from sales, not the bank deposits, it is helpful to account for all of the cash for a sample period to acquaint you with the business operations and to understand the taxpayer's policies on the use of cash.
- Apply the taxpayer's stated mark-up to purchases reported in the books. Is it consistent with reported gross receipts?

Cash management practices are a good indicator of the reliability of internal controls. If the restaurant or bar has no point-of-sales system that requires all transactions to be recorded, ask how they insure proper reporting and what measures are in place to discourage theft.

Internal controls can also be lacking in a system in which the controls designed for the point-of-sales system are not implemented, such as the recording of cash tips. This means that all of the cash received from customers is not accounted for and correct income is not reported. Usually in a bar, one person (for example, the bartender) may be handling all of the cash transactions including balancing out the cash drawers each day. This lack of separation of duties essential to a system of controls necessitates extending the income probe beyond the minimum required by the IRM.

### ***Additional Income Issues***

If additional income probes are needed, consider the use of a full bank deposit analysis, the net worth method, a source and application of funds analysis, or the specific item method. Additional probes usually require the use of third-party contacts and third-party contact procedures need to be followed. (See IRM 4.10.4.5.3 (4) and/or 4.10.4.5.2 (4)). It is necessary to get complete information about non-taxable sources of cash, which may explain any understatements. This is especially true of cash on hand and of cash hoards. (See IRM 4.10.3.8.4.)

Since the bar or restaurant industry is largely a cash-based one, the indirect methods discussed in this section may only show that an understatement of income exists. It may be hard or impossible to detect how the understatement was achieved. For example, the taxpayer may only be reporting income from one cash register when two are used, etc. The only way to possibly uncover this is to ask a lot of questions and keep your eyes open during the tour of the business. Another helpful technique is to visit the operation during its normal business hours and observe how transactions are handled. Additionally, you may find it useful to contact state regulatory agencies such as liquor control boards or gambling operations boards. These state boards routinely send agents to restaurants and bars to sit in on the business operations unannounced and observe the operations. They prepare a report of their observations, which may be available to the IRS examiner.

## ***Bar Income***

As in any income tax examination, the auditing techniques used depend on the quality and quantity of the taxpayer's books and records. If the taxpayer is a large bar that maintains inventory records which detail the daily and/or monthly purchases and sales of liquor, then the liquor cost percentage can be computed and applied to total purchases to determine the gross receipts and gross profit of the taxpayer. If the taxpayer is a small "Mom and Pop" bar that does not maintain detailed purchase and sale records, it may be difficult and time consuming to compute the purchases for one day or one month. In this case, it may be preferable to rely (at least in part) on third-party information to verify purchases and compute the mark-up on cost. The mark-up may then be applied to total purchases of similar items to approximate the business gross receipts and gross profit.

### *Using the Liquor Cost Percentage to Compute Gross Receipts*

To compute gross receipts using the liquor cost percentage, the following steps should be taken:

- a. Determine the cost of some of the more popular brands of liquor
- b. Determine the sales values of the bottle if all liquor out of these bottles were sold
- c. Divide the sales value into the cost to get the potential pouring cost

#### *Example 1*

Computing the liquor cost percentage:

- a. Determine the cost of liquor:  
The taxpayer's records and verification from third-party sources indicate that the cost per quart is \$4.48.
- b. Determine the sales value of the bottle:  
A quart has 32 ounces in it. If the taxpayer poured 1-1/4 ounces per drink, there would be 25.60 drinks per bottle. ( $32/1.25 = 25.60$ )

If the taxpayer sold the drinks for \$1.10, then the sales value per bottle less sales tax of \$1.97 would be \$26.19. ( $25.60 \times \$1.10 = \$28.16 - \$1.97 = \$26.19$ )

- c. Determine the pouring cost percent:

***Cost per bottle/Sales value = Pouring cost %***

This gives you the potential pouring cost percent.

$$\frac{\text{Cost } \$4.48}{\text{Sales value } \$26.19} = 17.1\%$$

- d. Determine the gross sales:

***Purchases/Pouring cost % = Gross sales***

If 17.1 percent is applied to total purchases of \$5,000, the gross receipts should be \$29,239.77 or ( $\$5,000/17.1\% = \$29,239.77$ ).

Gross Receipts (100%)	\$29,239.77
Less: Purchases (17.1%)	<u>(\$ 5,000.00)</u>
Gross Profit (82.9%)	\$24,239.77

*(Note: Using the formula discussed above, the computations could be used to calculate the total sales value of all bottles sold in a week or a month, etc. Consider a factor for waste and spoilage of about 5% to 8%. Also, subtract*

out the sales tax from the cost.)

*Using the Mark-up on Cost Method to compute the Gross Receipts*

If it is difficult to determine a taxpayer's daily and/or monthly purchases, the Mark-up on Cost Method may be used to compute gross receipts and gross profit. This method works closely with the liquor cost percentage method; however, different percentages are being determined.

As with the cost percentage method, the cost and sales value of the various items needs to be computed. Then, the mark-up on cost can be computed. Mark-up on cost is the amount of the sales price over the cost of an item.

*Example 2*

Simplified  
Sales Price 10.00  
Cost 5.00  
Goss Profit 5.00

Mark-Up on Cost = Sales price/Cost

$\$10.00/\$5.00 = 200\%$

The following steps should be taken to compute gross receipts based on mark-up on cost:

- a. Determine the mark-up of the various alcoholic items the taxpayer sells. The mark-up should be determined, if possible, in the initial interview. If the taxpayer does not know the mark-up of the bar items, you must compute it based on the sales price of drinks and the cost of the drinks.
- b. Determine the purchases made by the taxpayer.  
You can obtain this information from the invoices provided by the taxpayer, if available and accurate. If accurate records are not available, you should request the names of all of the vendors from the taxpayer in the initial interview. Following third-party contact procedures, send letters to the vendors requesting all records of purchases made by the taxpayer in the years under examination or contact other available sources.
- c. Apply the mark-up to the purchases of the various types of alcohol.

As in the earlier simplified example:

***Cost x Mark-up = Projected sales price***

Mark-up = 200%  
Cost = \$ 5.00  
Sales Price = \$10.00  
( $\$5.00 \times 200\% = \$10.00$  Projected sales price)

The steps discussed above do not take into account amounts for spillage, happy hour prices, etc. This information must be determined in the initial interview so that the taxpayer can be allowed these amounts in determining the correct gross receipts.

**Sales price per drink/Cost per drink/ mark-up of drink  
Computing the mark-ups on the various types of drinks.**

*Alcoholic Drinks*

Sales Price per Drink -- Take the average of the more popular drinks served in the bar, as stated by the taxpayer in the initial interview. It is also important to determine the amount of alcohol in each drink, comparing the taxpayer's

statements to a bartender recipe guide.

***Cost per drink = Bottle price / Number of drinks in bottle***

The bottle price is an average price of alcohol based on information from your local liquor dispensary.

***Draft Beer***

Draft beer is sold by the one quarter keg and one half keg. A one quarter keg contains 992 ounces of beer. A one half keg contains 1,984 ounces of beer. The beer distributors calculate that there are approximately 190 glass servings per one half keg and 93 servings from a one quarter keg. This calculation accounts for foam and spillage, which is common with draft beer.

Sales price is based on the price of the beer as listed on the menu and confirmed during the initial interview. Divide the sales price by the size of the drink to get the sales price per ounce. It is important to determine the size of beers served, ounces in each glass, pitcher, etc.

***Bottled/ Canned Beer***

Sales price of the bottled/canned beer is based on the price for the bottle according to the menu and the taxpayer's statements in the initial interview.

Cost of the beer is an average cost of beers available for sale by the taxpayer. Bottles and cans are usually sold by 12-pack or case (24); therefore, divide the cost by 12 or 24.

***Wine***

Sales price per glass is based on the price listed in the menu. Divide the sales price by the size of the glass to get sales price per ounce. It is important to determine in initial interview the ounces in each serving.

Cost of the wine is an average cost of wine available for sale by the taxpayer. Wine can be sold by the bottle, box, or keg, therefore, take the cost of the unit divided by the number of ounces to get a cost per ounce.

***Wine Coolers***

Sales price by the bottle is based on the menu price and confirmed by the taxpayer in the initial interview. Cost of the bottle is an average cost of wine available for sale by the taxpayer. Wine coolers are usually sold in case lots of 24. Divide the cost by 24 to get the cost per the bottle.

***Court Case on Percent of Markup Method***

The percent of markup method of establishing income is illustrated in *Cebollero v. Commissioner*, T.C. Memo. 1990-618, aff.d, 967 F.2d 986 (4th Cir. 1992). During 1982, 1983 and 1984, Manuel Cebollero owned a retail liquor store in partnership with his former wife. Because the Service was unable to confirm the percentage markups provided by Mr. Cebollero, the prices on Mr. Cebollero's price list and his cost of goods sold figures were used. The Service computed Mr. Cebollero's markup figures by dividing the sales price for each item on the price list by its cost. The Service made no adjustment for sales or discounts. This computation revealed that Mr. Cebollero's mark-up was exactly what he said it was. It also revealed a large understatement of gross income.

The Court largely agreed with the Service, but allowed an adjustment for items sold at sale prices.

***Employee Tip Income Reconstruction Using Indirect Methods***

Employee tip income is income under IRC section 61 and Treas. Reg. section 1.61-2(a) (1) and can be reconstructed using indirect methods. The percentage markup method is one of the most often used methods to reconstruct unreported tips, although the cash expenditures method is also used. The McQuatters formula is also a common method to determine the tips as an hourly amount, a percentage of gross sales or receipts, or a percentage of the taxpayer's wages.

The McQuatters formula is illustrated in the case from which it gets its name, *McQuatters, et. al. v. Commissioner*, T.C. Memo. 1973-240. During 1967 and 1968, Lorna McQuatters was employed as a waitress at the Space Needle

Restaurant. Ms. McQuatters kept no records of her tip income for these years. Therefore, the Service determined her tip income indirectly by the following method: (1) total sales of food and beverages reduced by 10 percent to allow for low or no tips and tip-sharing; (2) this amount (that is, sales subject to tips) was divided by the total number of hours worked by all waitresses during the year to arrive at sales-per-waitress-per-hour average; (3) this average was multiplied by the number of hours in each year that Ms. McQuatters worked to determine her yearly sales; and (4) her yearly sales were multiplied by 12 percent to compute her yearly tip income.

The Court reduced the tip income percentage from twelve percent to ten percent. Otherwise, because Ms. McQuatters kept no records of her tip income, the Court upheld the Service's determination.

*(Note: Extending the income tax examination of the restaurant to include employee examinations should be coordinated with the employment tax group. If you believe an employee examination is warranted, contact your Area employment tax group or make a referral.)*

#### *Income from Coin-Operated Activities*

Coin-operated machines located in bars or restaurants constitute another important source of income. Coin-operated machines may include jukeboxes, cigarette machines, pool tables, dart boards, video games, candy machines, etc. These machines can be owned by the taxpayer or leased from another party. If the machines are leased, the general rule is that the income generated from the machines is split based on some percentage determined by the owner of the machine.

Income generated from coin-operated activities is very difficult to determine accurately. Therefore, the examiner will review the contracts and question the taxpayer in the initial interview regarding the operation and income generated by these machines. It may be necessary to secure third-party information to compute this income. Additionally, it may be helpful to check Internet resources including the Small Business Administration. Many vending machine companies also have information regarding average annual sales per machines.

#### **Rebates from Supplies**

It is common practice in the restaurant industry for suppliers to enter into supplier arrangements with restaurants. Typically, these arrangements extend beyond the taxable year. For example, suppose that Supplier A enters into an agreement with a restaurant chain to supply soft drink concentrate. The contract states that the supplier will advance \$5,000,000 to the restaurant chain immediately and in return the restaurant agrees to purchase all of its soft drinks from Supplier A for the next 5 years. The Service's position is that upfront payments received under supplier agreements are income upon receipt.

Other Potential Sources of Income Activities include:

- Lottery tickets
- Gaming pools
- Vending machines
- Franchise rebate income
- Tenant/fixture allowance
- Supplier or advertising rebates/incentives/reimbursement
- Sales of assets
- Cover charges for admissions
- Selling concessions at sporting events/banquets/high schools
- Renting out rooms for weddings and birthdays, etc.
- Catering
- Banquets
- Bartering
- Related party transactions
- Kickback from vendors
- Renting space for signs and video machines



These possible sources of income should be considered during the initial interview. The examiner will ask pertinent questions to determine if the taxpayer engages in these activities and how any income, including cash, is handled and reported on the tax return.

## Cost of Goods Sold

The use of statistical and ratio analyses is a useful pre-audit tool for an examiner. This can tell the examiner if the Cost of Goods Sold is overstated or out of balance in comparison with reported Gross Receipts. This could occur when the inventory amounts are 'estimated', when there is theft or personal use of inventory, or when gross receipts are under-reported.

Statistical and ratio analyses are not tests of the reliability of reported income or expenses and cannot be substituted for an income probe audit step. Rather, the use of statistics and ratio analysis in pre-audit may indicate that additional audit steps are warranted. The examiner still needs to perform audit tests to determine if the taxpayer's books and records can be relied upon and must use direct or indirect methods to determine gross income. If necessary, however, ratios can be used to support audit conclusions arrived at using these methods.

Perform a comparative analysis for the current year, the prior year and the subsequent year.

*Calculate Gross Profit Ratio (for at least three years)*

$$\frac{\text{Gross Sales} - \text{Cost of Goods Sold}}{\text{Gross Sales}} = \text{Gross Profit Percentage}$$

This ratio shows how much of the sales represent gross profit.

Compare the gross profit percentage (GPP) with the ratios of similar businesses. You can use BizStats.com or Restaurant.org for this information. The GPP should be consistent with industry standards and be sufficient to produce a net profit.

Compare the GPP of the current year to the prior and subsequent years' GPP. The GPP should be consistent in a business from year to year. A low GPP may indicate a problem with inventory valuation.

The examiner should ask the taxpayer for their mark-up percentage during the initial interview and compare that percentage with the calculated GPP. Any discrepancy should be followed up with the taxpayer and the explanation should be recorded in the work papers.

*Example of GPP Calculation:*

Gross Sales	\$100,000	100%
Cost of Goods Sold	\$70,000	70%
Gross Profit	\$30,000	30%
$\frac{\$100,000 - \$70,000}{\$100,000}$	= 30% GPP	

*Inventory Turnover (for at least three years)*

$$\frac{\text{Cost of Goods Sold}}{(\text{Beg Inventory} + \text{End Inventory}) / 2} = \text{Inventory Turnover Rate}$$

This ratio computes the number of times the inventory ‘turned over’ or was sold during the year. It is an indicator of a business’s profitability because when inventory turnover decreases, sales and net profit decrease. Conversely, when inventory turnover increases, sales and profits increase. This is because the goal of all retailers is to sell the inventory at a profit and buy more.

Compare the inventory turnover rate with the ratios of similar businesses. You can use BizStats.com or Restaurant.org for this information. The inventory turnover should be consistent with industry standards.

Compare the turnover of the current year to the prior and subsequent years’ inventory turnover. This will show if purchases and sales are consistent from year to year. Any deviations should be questioned.

A low inventory turnover rate should be questioned.

Compare the inventory turnover rate to the GPP. The ratios should parallel each other: increased GPP will be coupled with increased inventory turnover rate. If the GPP has decreased from last year, but the inventory turnover has increased, the Cost of Goods Sold may be overstated and/or the inventory amounts are not correct. This should be questioned and recorded in the work papers.

*Example of Inventory Turnover Rate:*

Beginning Inventory \$156,000  
 Ending Inventory 178,000  
 Cost of Goods Sold 700,000

$$\frac{\$700,000}{(\$156,000 + \$178,000) / 2} = 4.19 \text{ times during the year}$$

*Percentage of Increase or Decrease in Ending Inventory (for at least three years)*

$$\frac{\text{End Inventory} - \text{Beg Inventory}}{\text{Beg Inventory}} = \% \text{ Change in Inventory}$$

This ratio shows any significant variations from year to year. It can indicate an overstatement in Cost of Goods Sold.

Compare the % change in ending inventory balances of the current year to the prior and subsequent years’ amounts. Any significant increase or decrease in ending inventory should be questioned.

*Example of Change in Ending Inventory Balance:*

Beginning Inventory \$156,000  
 Ending Inventory \$178,000

Cost of Goods Sold	\$700,000	
$\frac{\$178,000 - \$156,000}{\$156,000}$	=	14.10%

Ratio patterns can indicate unreported income and suggest a need for additional income probes. For example, an analysis of a restaurant return indicates that the restaurant has suffered losses for 3 consecutive years or longer and has a high ratio of cost of goods sold to sales. It is reasonable to question the source of the cash necessary for the restaurant to continue operating under these circumstances.

Inspecting the cash flow statement may pinpoint potential sources and assist in preparing a Source and Application of Funds.

If the same restaurant showed an increasing inventory turnover rate (indicative of increased profits), it would be reasonable to question the veracity of the inventory and purchases. Overstated Cost of Goods Sold lowers income.

Once the examiner has the books and records they can analyze the ratio of sales per employee. If this ratio is low relative to the industry, it may be useful to inquire about the turnover ratio of the employees. If, by inspecting the Forms W-2 and payroll records, it appears that the turnover ratio is high, it may be reasonable to assume that the recurring cost of employee training is the cause of the relatively low sales per employee. A restaurant with high employee turnover may not be entitled to take the Work Opportunity Credits or the Welfare to Work Credit. (See IRC sections 51 and 51A.)

#### *Other Ratios*

Following are some additional ratios that can be calculated using the facts from the books and records, and compared to industry statistics. The examiner should question the taxpayer regarding any discrepancy and record the taxpayer's response.

- a. Prime Cost % = Prime Cost (cost of food and beverage sold plus Labor cost)/Total Sales
- b. Food Cost % = Food Cost /Food Sales \*
- c. Labor Cost % = Total Labor Cost/Total Sales
- d. Liquor Cost % = Liquor Cost/Liquor Sales
- e. Wine Cost % = Wine Cost/Wine Sales
- f. Beer Cost % = Beer Cost/Beer Sales
- g. General and Administrative % = General Administrative Cost/Total Sales
- h. Sales per Seat = Total Sales/Number of Restaurant Seats
- i. Sales per Square Foot = Total Sales/Restaurant Square Footage
- j. Sales per Labor Hour = Sales/Full Time Employees
- k. Inventory Turnover = Cost of Goods Sold/Average Inventory

\*Food cost includes coffee, tea, and juices sold with the meal. If no alcohol is sold, food costs include soft drinks.

## **Expenses**

### *Package Design Costs*

Food and beverage companies incur significant costs in developing package designs for their products. Package design costs are costs incurred to develop the shape, size, graphics, etc. on a product package. The Internal Revenue Service has issued guidance in the form of a coordinated issue paper and several Revenue Procedures (Revenue Procedures 90-63, 97-35, 97-37, 98-39) and Revenue Ruling 89-23 stating that these costs are capital in nature and depending upon the election a taxpayer makes, are recoverable over four or five years.

The issue was litigated (RJR Nabisco, Inc., et al., v. Commissioner. T.C. Memo. 1998-252). the taxpayer convinced the court that package design costs are merely a form of advertising (point of purchase advertising), and as such are

currently deductible. The Internal Revenue Service argued that although there are some advertising characteristics present, the fact that there is a long term benefit dictates that these costs are capital in nature and therefore must be capitalized.

The final regulations on capitalization of intangibles were issued in December, 2003. One major impact in the food industry deals with package design costs. It is extremely important to remember that the final regulations are effective for package design costs incurred on or after December 31, 2003. The final regulations are not retroactive. Some taxpayers have filed claims to expense package design costs and these claims should not be allowed! The package design coordinated issue paper is still effective for costs incurred prior to December 31, 2003. The package design cost coordinated issue paper will not be de-coordinated for several more years, since we are currently examining years prior to 2003. Several cases have gone to Appeals and they are supporting us on this issue.

On March 24, 2004, guidance on accounting method changes for capitalization of intangibles was issued in the form of Revenue Procedure 2004-23. This revenue procedure only applies for a taxpayer's first taxable year ending on or after December 31, 2003. It should be noted under the final regulations that the section 481(a) adjustment is determined by taking into account only amounts paid or incurred in taxable years ending on or after January 24, 2002.

The Service has received several Form 3115s from taxpayers seeking to change to expense package design costs prior to the effective date of the final regulations. These requests have been denied by the Service. Taxpayers should be filing amended returns for these prior years (capitalizing package design costs) in order to be eligible to use this revenue procedure. You will want to refer to the revenue procedure for specific examples and special rules.

Revenue Procedure 2005-09 was issued for the taxpayer's second year ending on or after December 31, 2003.

#### *Charitable Contributions of Food Inventory*

The rules for charitable contributions of food inventory are slightly different from ordinary contributions of inventory because Congressional intent is to encourage charitable contributions of excess food that would otherwise go to waste.

IRC Section 170(e) (3) allows an enhanced deduction for qualifying contributions of food inventory. This deduction is equal to the basis of the property contributed plus one half of the appreciation, not to exceed twice the basis. This amount would be treated as a contribution and cost of goods sold would be reduced by the basis of the property contributed. More information can be found in [Publication 526 Charitable Contributions section on Food Inventory](#).

Areas to inspect include if a Taxpayer took the enhanced deduction but did not reduce cost of goods sold by the basis of the property, or that the contribution was made to an organization that is not a qualifying organization.

#### *Depreciation Accounting Method Change Issue*

The government has been considering how best to address three court losses – Brookshire Bros. Holding Inc., v. Commissioner, T.C. Memo. 2001-150, aff'd., 320 F.3d 507 (5th Cir. 2003), Green Forest Manufacturing Inc. v. Commissioner; T.C. Memo. 2003-75; and O'Shaugnessy v. Commissioner, 332 F. 3d 1125 (8th Cir. 2003), rev'g 2001 U.S. Dist. LEXIS 227838 (D. Minn. 2001). These cases involved taxpayers who used a change in accounting method to maximize their depreciation. Typically, we will see this on Cost Segregation Studies. Guidance was recently released clarifying the government's position in regards to this controversy.

The IRS has published final, temporary, and proposed regulations on whether a change in depreciation or amortization is a change in method of accounting under section 446(e). Effective January 2, 2004, the regulations clarify that, as a general rule, a change in depreciation method, period of recovery, or convention of a depreciable or amortizable asset is an accounting method change. The regulations also clarify that changes to or from a useful life, in salvage value, from single asset accounting to multiple asset accounting, from multiple asset accounting to a

different type of multiple asset accounting, and from non-depreciable to depreciable asset treatment are changes in accounting method. The regulations identify several exceptions concerning timing issues. Examples 9 and 10 of the regulations deal specifically with cost segregation studies.

*Smallwares (Dishes, Glasses, Silverware, Pots etc.)*  
(See Rev. Proc. 2002-12).

The trade or business of operating a restaurant (or tavern) requires the use of many items in the preparation, service, and storage of food and beverages. Pots and pans, dishes, silverware, linens, small kitchen appliances and glassware are common examples of these items, known as “**smallwares**” in the restaurant industry.

Before a restaurant opens for business they must purchase all of these small wares. For a full service restaurant with one location, this may be between \$50,000 and \$70,000. Since these would be acquisition costs, which are included in start-up expenses, the cost is subject to IRC section 195 and must be amortized, not deducted.

During the operation of a restaurant, glasses and plates are broken, silverware is lost or destroyed in disposals, napkins are soiled beyond repair, and these items must be replaced. Prior to 2002, restaurant supplies were depreciated over a 5 year class life.

Beginning in 2002, taxpayers engaged in the trade or business of operating a restaurant or tavern can treat the cost of replacement smallwares as non-incidental materials or supplies under Reg. §1.162-3. Consequently, the costs are deductible in the taxable year in which they are received at the restaurant and are available for use. For purposes of this revenue procedure, “received at the restaurant and available for use” does not include smallwares purchased and stored at a warehouse or facility other than the restaurant where the smallwares will be used.

*Change in Method of Accounting - Smallwares*

If the restaurant is changing from the previous method of depreciating smallwares to this method of expensing the costs, this is a change in their method of accounting to which §§446 and 481 apply. A taxpayer that wants to change its method of accounting for the cost of smallwares to the smallwares method provided in this Rev. Proc. must follow the automatic change in method of accounting provisions of Rev. Proc. 2002-9, 2002-3 I.R.B (or its successor) with the following modification: the scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply.

If this issue is under examination when the taxpayer makes the change in method of accounting, a copy of the Form 3115, Application for Change in Accounting Method, is filed with the national office, and, the taxpayer must provide a copy of the Form 3115 to the examining agent.

The adjustment for the cost of smallwares must take the entire net amount of any §481(a) adjustment into account in computing taxable income for the year of change.

*Audit Protection - Smallwares*

If a taxpayer complies with the requirements of this revenue procedure and changes its method of accounting for the cost of smallwares to the smallwares method provided in this revenue procedure, the treatment of those costs will not be raised as an issue in any taxable year before the year of change and, if the treatment of the cost of smallwares has already been raised as an issue in a taxable year before the year of change, that issue will not be further pursued.

*Losses Incurred when a Restaurant is closed*

Is a taxpayer entitled to deduct the difference between the adjusted basis of the property and its appraised value when a location is closed but not disposed of? In the restaurant industry approximately 80 percent of all new restaurants go out of business within 2-3 years. Conversely, franchised restaurants and national chain restaurants have an 80-90 percent success rate. Some taxpayers are taking the position that when the building is owned, they are entitled to a loss in the form of bonus depreciation equal to the difference between the adjusted basis and the appraised value of the building, when a decision is made to close an unprofitable location. Members of the National Restaurant Association have been working with the Food Technical Advisor to determine what the correct tax position is, given this fact pattern. The National Restaurant Association has requested that this issue be

coordinated because both taxpayers and revenue agents during examination are taking inconsistent positions. FSA 200029054 was issued in 2000. The Food Technical Advisor has taken the position that a loss on the Section 1250 property is not allowed until an actual disposition (sale or abandonment) has occurred. The mere closing of the store is not an actual disposition. ***Once the Office of Chief Counsel has given an opinion, consideration will be given to coordinating this issue.***

### ***Depreciation and Cost Segregation Studies***

The allocation of costs of a restaurant between Section 1245 and Section 1250 is an issue that is usually examined. Restaurant buildings owned by the business can be depreciated under the Modified Accelerated Cost Recovery System (MACRS) for 39 years. Some elements of buildings, however, can be separated and identified as tangible personal property. This practice is called cost segregation, which allows recovery of the personal property elements of a restaurant building over a five-year period using the 200-percent declining balance method. The personal property elements qualify for IRC section 179 expense deductions and bonus depreciation under IRC section 168(k). This separate valuation of real and personal property can also reduce state and local taxes imposed on real property.

The portions of the building that are classified as structural components are considered real property and are included in the depreciable basis. The portions of the building that are classified as personal property are separately depreciated.

Following are the classifications that would apply to restaurants:

#### ***Change in Method of Accounting - depreciation***

If the property was originally placed in service using MACRS after 1986, without cost segregation (that is, without allocating any costs to personal property), and the taxpayer now wants to make the allocation, they must get permission to change their accounting method pursuant to Rev. Proc. 2002-9, App., §2.01. Under this revenue procedure, a taxpayer is allowed to reclassify building elements as personal property and claim a deduction for the depreciation that should have been claimed on those elements.

#### ***Rebates to Franchisees from Suppliers***

It is common in the restaurant industry for individual restaurant owners and franchisees to receive rebates from suppliers. These rebates usually come from soft drink distributors, french fry suppliers, and bakery/bread items. In most instances these payments are to individuals versus the corporation. Taxpayers may not be issuing 1099's to the recipient. These payments are includible in income of the recipient.

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## **Web Resources for Restaurants**

- [Nation's Restaurant News](#)
- [National Restaurant Association](#)
- [Food Institute, Other Food Industry Resources](#)
- [Wine Institute](#)
- [Restaurants for Sale - World Wide](#)
- [CuisineNet](#)

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## **Glossary**

***Allocated Tips*** Tips that the employer assigns to the employee in addition to the tips reported by the employee to the employer when tips reported are less than 8 percent of food and drink sales. The employer reports the allocated

tips to the IRS on the Form W-2. The employee completes Form 4137 which is attached the employee's tax return. Employer does not pay FICA tax on allocated tips.

**Autogratiuity** An autogratiuity is a service charge that is automatically posted to a guest check. An autogratiuity affects all items that are linked to it. Percentage autogratiuities are different from regular percentage service charges. A 15-percent autogratiuity is updated by a point-of-sales system even when checks are split. A regular autogratiuity is applied once at the end of the transaction.

**Automated Bar Control Systems** Computer based systems to control the bar and alcohol operations. This includes a metered system and a keg beer control system. These systems record the number of drinks dispensed, portion sizes, drink pricing, and collect other data on sales such as brand, serving station, hour, and drink type.

**Basic Cash Register Machine** Has a paper tape of all recorded transactions, an internal meter that records cumulative data totals, and a cash drawer that secures cash receipts. Allows for recording of various food and beverage items, has a sales tax key, and change due. Tips are not recorded.

**Call Drink** A drink made with a name brand liquor. The brand is usually requested by the customer.

**Cashier Banking** A central cashier handles payments. Server takes order from the customer, and the cashier rings up the sale, the server takes payment from the customer and gives to the cashier who rings up the payment and makes change and gives the information back to the server to give to the customer. At the end of the shift, the cashier balances out the sales drawer and gives the server a copy of the server's sales and tip report.

**Charged Tip** Charged tips are tips added to a credit card slip or a room charge slip. Charge tips are paid to the server by the restaurant, since the restaurant receives the full amount of the credit as a deposit to its bank account.

**Check employee** Employee who deals directly with the customers such as the waiter or server who takes the order and brings the food to the customer. The same employee also gives the customer the check or sales slip, and receives payment from the customer.

**Check digit verification** Validates the accuracy of credit card account numbers that are entered during transaction processing.

**Complementary (Comp) Sales** A meal or drink that is served, but the customer is not required to pay. This may happen as management courtesies meals for errors made or for friend's meals. Generally, a tip is left as in the case of a regular paying customer.

**Cover Charge** Charge for admission into restaurant and bar, usually because of live entertainment.

**Diner Discount Funding Programs (DDF)** A funding source provides the restaurant with a cash advance that can be used however the owner chooses. In exchange, the funding source receives food and beverage credits generally equal to twice the cash advance amount. The funding source then provides credits to members who redeem them by signing special credit card receipts for their bills at full price. The restaurant receives a check from the funding source for the tax and tip amounts. The remainder of the bill is applied to the restaurant's advance balance. Revenues are deferred and may not be ever recorded as current income.

**Directly Tipped Employee** This is an employee who receive tips from the customer directly.

**Employee Banking** Employees who maintain their own 'bank' of cash, usually a purse or pouch. The employee takes orders from customers, takes payment from customer, makes change for customer from the 'bank', and keeps records of all sales. The sales total is balanced out against the cash register at the end of the shift.

**Employee Tip Report** In a point-of-sales system, employee tip reports are printed out at the end of each day. This same report can be cumulated and printed out for each payroll, quarter, or annually in a point-of-sales system. The following totals are included in each report:

1. Gross Receipts (total sales credited under the employee's name)
2. Credit Card Sales (total charged sales)
3. Credit Card Tips (total tips received from credit card sales by employee)
4. Cash Sales (total cash sales under each employee's name)
5. Service Charge receipts (total service charges payable to the employee)
6. Cash Tips Reported (total cash tips reported by employee)

**Employee meal** Meal eaten on the premises by the employee. Usually considered a nontaxable fringe benefit as a meal provided for the convenience of the employer. Most point-of-sale systems have a separate key for recording employee meals.

**Employer FICA Tax Credit** Credit against income tax for amount of employer FICA tax paid on employees tips.

**Employment Tax Audit** Audit of the Forms 941 and 940 for both the employer's share of FICA and the employee's share of FICA and withholding tax.

**Expanded Cash Register Machines** Records sales, server information, guest check information, discounted meals, promotional or complementary meals, employee meals, and identifiable menu items.

**Fast Food Restaurant** Does not employ servers who take orders. Customers will place and pick up their own orders and often bus their own tables.

**Food Cost** The cost of all food items purchased for resale; does not include the cost of supplies. Usually expressed as a ratio of Food Cost/Total Food Sales.

**Food Cost Percentage** The portion of cost divided by the menu price.

**Franchise Fee** Cost paid to franchise owner for operating a franchise. Other franchise costs include royalties, advertising, rent, etc. The fee to purchase a franchise is amortized. The annual franchise fees to pay advertising, etc. are usually currently deductible.

**Full Service Restaurant** Servers are employed to take orders and may include alcohol services.

**Guest Check Information System** Produced by the integrated point of sale system, a guest check is created showing the written description of the order, server's name, number of customers, table number, and how paid, and tip.

**Guest Seat** Usually each chair in the restaurant is kept track in a point of sales system. Also, each server is assigned a chair or seat. The information used can show how many sales are recorded by each chair or seat.

**Indirectly Tipped Employee** An employee who receives tips from directly tipped employees through either tip pooling or tip splitting. In a point-of-sales system, employees record their cash tips in the system using an indirect tips or direct tips key.

**Integrated Point of Sales Systems** Cashiering functions of the expanded cash register machines plus order entry or automation of the ordering process. It captures the order from the time that it is taken, to transmission to the kitchen area, to the time of payment. Time recording is also possible with a link to an actual time clock. Can be linked to a back office computer to convert data into a management analysis system of the data collected.

**Keg Beer Control System** A push button panel that dispenses the exact portion of beer replaces the conventional beer tap. This is a system usually employed to control portions and prevent theft.

**Liquor License Fee** Cost of maintaining right to serve alcohol, usually to a government agency. After RRA '93, this intangible asset can be amortized over 15 years for licenses acquired after August 10, 1993. Per GAAP, APB Opinion No. 17 requires disclosure of write-off and use of straight-line method.



**Liquor Cost** The amount paid for liquor after discounts; does not include bar supplies, mixers, etc. Usually expressed as a ratio: Liquor Cost/Liquor Sales.

**Liquor Cost Percent** The portion cost divided by the selling price.

**Menu Price** The amount that will be charged to a customer for the item.

**Menu Pricing** A technique of calculating the actual cost of goods sold by cost to purchase each ingredient within each item of the menu. For example, determining the cost of a hamburger bun, slice of cheese, and meat. Based on the cost, a profitable selling price for each menu item can be determined.

**Metered Systems** A system using a metering device to record each drink served. They attempt to hold the bartender accountable for every drink poured. Some systems use a "gun" dispenser that travels through a system of hoses from the storeroom where the liquor is kept to the gun. Other systems use a spout attached to each bottle that dispenses a predetermined portion. The bartender must attach a collar around the spout to activate. The collar records the drink and releases the alcohol.

**Net Purchase Price** The price paid by the restaurant for one unit (that is, pound, package, container, etc.)

**Point of Sales System** Usually computerized type of sales register that records the sale at the time the sale occurs. This can include basic electronic cash registers, expanded cash registers, and integrated point of sales systems.

**Portion Cost** The unit cost times the portion served.

**Portion Served** The amount of an item served to a customer in an order.

**Restaurant capacity** The amount of customers that can be served if all of the tables and chairs available for use, are used.

**Restaurant Development Costs** Start-up costs to find a restaurant location, train employees, pre-opening advertising costs, fees paid for demographic studies. Under IRC section 195, these costs are required to be amortized over 60 months.

**Service Charge** A service charge is any gratuity posted to a check, such as a room service or delivery charge. Direct and indirect tips are not service charges. A point-of-sales system will record a service charge.

**Shrinkage** The amount lost as a result of cooking or waste.

**Spillage** The amount of alcohol lost during the drink making process.

**Stiff** A stiff is when a customer leaves no tip.

**Targeted Jobs Credit** Credit against tax for employing targeted groups.

**Tip Audit** Audit of the employer's share of FICA tax on all the tip income of the employees and not just the tips reported to the employer. Special procedures require involvement with the Tip Coordinator for assessment.

**Tips Paid** Tips paid out by the restaurant to the server for the credit card tips at the end of the shift when the server cashes out. These tips reduce the cash in the drawer from cash sales and reduce amount deposited to the bank in cash. These tips are recovered when the restaurant receives payment from the credit card companies.

**Tips Declared** Amount of cash tips reported by the employee to the employer. This is not necessarily the amount of cash tips received.

**Tip Percentage** The tip percentages is calculated as follows:

Employee's total tips/employee gross sales receipts = tip percentage.

**Trade-out** Trade-out arrangements are barter activities where the restaurant agrees to provide meals in exchange for some activity.

**TRDA Agreements** The Service will work with the employer to arrive at a tip rate for the various occupations in the restaurant using the McQuartter's Formula. At least 75 percent of tipped employees must sign a participating agreement. Participating employees report tips at or above the rate determined in the agreement.

**Tip-outs** These are tips shared from directly-tipped employees to other directly and indirectly-tipped employees, such as bus persons and cooks.

**Tip Pool** In some instances the employees will put all of their tips together and then divide them equally or on a percentage basis. Sometimes they are divided based on hours worked.

**Tipshare** This is when a directly-tipped employee shares his/her tips with an indirectly-tipped employee.

**TRAC Agreement** The employer and the Internal Revenue Service agree to institute and maintain a quarterly educational program that trains newly hired employees and periodically update existing employees as to their reporting obligations with respect to tips. The employer also agrees to establish a procedure to monitor the employees, the accurate reporting of all tips, and comply with all federal tax requirements regarding the filing of returns, paying and depositing taxes, and maintaining records.

**Unit Cost** The purchase price divided by the applicable unit.

**Walk-out** This is when a customer leaves the premises without paying the bill.

**Weekly Profit and Loss Reports** Internal reports reconciling cash register tapes, deposits, purchases, and cash payouts. Reports provide detailed analysis of sales and costs. These are usually available on all electronic cash registers.

**Well Drink** A drink made with the less expensive non-name brand liquors.

**Work Opportunity Tax Credit** Credit employers can receive for hiring people off of welfare.

## Statistics

See the [National Restaurant Association](#) website for statistics information.

## Grocery Stores

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### Initial Interview Questions

*Questions to ask concerning sources or adjustments to income include:*

1. Which redemption companies do you use to redeem coupons and rebates?
  - How often do you process the coupons/rebates?
  - Approximate amount of coupons redeemed?
  - How many are directly attributable to gross receipts?
  - How many are in-store coupons?
  - How many are through manufacturers/suppliers?
  - How many handling fees were charged by the coupon redemption companies?
  - Were ledgers kept on coupon redemption?
  - Who and where are the coupon checks (procedures) cashed?
  - Who endorses the checks?
2. Who gets the manufacturers/brokers premium gifts?
3. Is the store an authorized retailer in the Food Stamp Program?
4. Is the store an authorized retailer in the Women, Infants and Children (WIC) Program?
5. Does the store accept credit cards?

### Income

Lack of compliance centers on the non-reporting of several types of income prevalent within the industry. Grocery gross receipts are attributable to:

- Coupons
- Coupon Processing Fees
- Rebates
- Value of Vacation Trips; and Other Types of Gifts
- Cash Discounts
- Receipt of High Dollar Promotional Items
- Pay Telephones
- Bottle/can Redeeming
- Money Orders
- Video/DVD Rentals
- Video/DVD Game Rentals
- Credit Card Sales
- Food Stamp Sales
- WIC Program Sales
- Prepaid Telephone Cards

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

#### *Coupon Income*

The taxpayer receives a fee for processing coupons. Keep in mind that the amount credited for coupons could

include the coupon handling fees. If the amount credited for coupons exceeds the amount debited throughout the year, the taxpayer is redeeming more coupons than his customers brought in to be tendered. This may result from the taxpayer cutting coupons to be redeemed and may reflect a potential source of unreported income. Retailers should report the income from a coupon's face value and its related handling fee at the time the coupon is received from the customer.

#### *Rebate*

Grocery stores receive many product rebates based on volume and increased purchases over prior years. Grocers receive rebates for almost all areas, but are more prevalent in dairy products, snack items, cigarettes, film processing, meat products, candy, bread, and related items. A technique to use to identify these transactions is the submission of a listing of suppliers to the taxpayer requesting the taxpayer to indicate the supplier(s) they received rebates from and the frequency of receipt. From this listing the taxpayer's books and records and/or deposit slips can be checked to partially verify the taxpayer's statements. Shelving or slotting allowances are nothing new to the industry. Grocery stores charge manufacturers substantial amounts each year for prime shelf space to display their products. Please note that vendor allowances are an issue being considered by the Retail Technical Advisor.

#### *Promotional Items*

It is a normal practice for some suppliers' sales representatives to give gifts or cash to the individuals/shareholders for buying their products instead of another supplier's products. Some of the items individuals have received include televisions, computers, telephones, microwave ovens, lawn furniture, coolers, jackets, video/DVD games and movies, value of vacation trips; food, beverages, and paper products delivered to their homes, and professional and collegiate sport team tickets. If the grocery store is incorporated and the suppliers give promotional items directly to the shareholders, adjustments may be necessary to increase corporate receipts and to report a constructive dividend.

#### *Courtesy Account*

Many grocery storeowners maintain a customer courtesy account, a petty cash account, or a similar bank account that is completely 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. It is suggested the examiner inquire 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.

#### *Demonstrators*

The taxpayer may have a business where individuals demonstrate products and distribute the coupons of the taxpayer's suppliers in the grocery store. When the suppliers request demonstrations at a particular time and store, the taxpayer contacts individuals, referred to as demonstrators, from a list the taxpayer has compiled.

Some taxpayers will enter into a written contract with the demonstrator, indicating the demonstrator is being hired on a contractual basis. The taxpayer may instruct the demonstrator on specifications by which the demonstrator would have to adhere, including not being permitted to hire assistants or replacements. Otherwise, the demonstrator is free to employ his/her own methods in performing the demonstrations.

Demonstrators are not guaranteed a minimum amount of work, they are not required to accept jobs when the taxpayer contacts them, and the failure to accept a job does not affect their name on the demonstrator's listing. The demonstrators are not prohibited from performing demonstration jobs offered to them by competitors. Demonstrators typically work a maximum of sixteen hours per week and are paid a set hourly wage for each demonstration. Demonstrators accepting jobs are sometimes asked to bring some supplies with them for which they are reimbursed. The product being demonstrated is always provided by the taxpayer.

The taxpayers may be treating the demonstrators as independent contractors; however, they *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 taxpayers over the demonstrators in this issue and that exercised over the interviewers in the two revenue rulings is similar. Refer to the revenue rulings for a more thorough explanation.

In some cases the demonstrators' wages were netted under promotional income, therefore, avoiding employment taxes.

### **Cost of Goods/Inventory**

When examining a grocery store operation, consider performing the following checks on purchases and inventory:

1. 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.)
2. 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.
3. 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.)
4. 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.)
5. 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.

These are the usual 11 categories accounted for IRC § 263A:

- Food and Beverages
- Housing Maintenance and Repair Commodities
- Fuels (other than gasoline)
- House Furnishings and Housekeeping Supplies
- Apparel
- Toilet Goods and Personal Care
- Medical Care
- Entertainment
- Tobacco
- Private Transportation (including gasoline)
- School Books and Supplies

## Chapter 5: Code, Regulations and Revenue Rulings, Procedures, Court Cases, and IRMs

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### *Cited Code Sections*

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IRC § 38	Investment tax credit	2-27
IRC § 41	Systematic scheme to obtain losses and credits that are not allowable	3-9
IRC § 51 and 51A	Work Opportunity Credits or the Welfare to Work Credit	2-26
IRC § 61	Gross income consists of all income, from all sources, such as compensation for services, business income, interest, rents, dividends and gains from the sale of property. Only items specifically exempt may be excluded. Gross income is the starting point in determining tax liability and is broadly defined.	3-97
IRC § 74(a)	Except as otherwise provided in this section or in section 117 (relating to scholarships), gross income includes amounts received as prizes and awards.	3-97
IRC § 102(c)	In regards to employee gifts, subsection (a) shall not exclude from gross income any amount transferred by or for an employer to, or for the benefit of, an employee.	3-97
IRC § 162	Specifically focuses on the issue of trade or business expenses	2-25, 3-44
IRC § 168	Specifically includes as 15-year property “any IRC section 1250 property which is a retail motor fuels outlet (whether or not food or other convenience items are sold at the outlet).”	3-23, 3-41
IRC § 168 (k)	Bonus Depreciation	2-26, 3-41
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IRC § 170(e) (3)	Charitable contribution-Special Rules	2-25
IRC § 179	MACRS personal property election	2-26, 3-20
IRC § 183	In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.	3-9, 3-97
IRC § 183(d)	If the gross income derived from an activity for 3 or more of the	3-97

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	taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, unless the Secretary establishes to the contrary, such activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit. In the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, the preceding sentence shall be applied by substituting “2” for “3” and “7” for “5”.	
IRC § 183(e)(4)	Time for assessing deficiency attributable to activity.--If a taxpayer makes an election under paragraph (1) with respect to an activity, the statutory period for the assessment of any deficiency attributable to such activity shall not expire before the expiration of 2 years after the date prescribed by law (determined without extensions) for filing the return of tax under chapter 1 for the last taxable year in the period of 5 taxable years (or 7 taxable years) to which the election relates. Such deficiency may be assessed notwithstanding the provisions of any law or rule of law which would otherwise prevent such an assessment.	3-97
IRC § 195(b),	Start-up expenditures may, at the election of the taxpayer, is treated as deferred expenses.	
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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.	3-55
IRC §461	Rule(s) for Year of Deduction	
IRC §471	Inventories must conform as nearly as may be to the best accounting practice in the trade or business and must clearly reflect income	2-17, 3-38, 3-72
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IRC §1001(b)	The amount realized from the sale is the cash plus the fair market value of any other property received.	3-83
IRC §1245	Depreciation - shorter cost recovery period	2-26, 3-41
IRC §1250	Depreciation – recovery periods	2-26
IRC § 1253	Amounts paid or incurred on account of 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	2-24
IRC § 1401	Imposes taxes upon the self-employment income of every individual.	3-97
IRC § 1402(a) and (b)	Define “self-employment income” as the gross income derived by an individual from any trade or business carried on by the individual with certain exceptions and exclusions.	3-97
IRC § 3121 (q)	Requires the Employer to match the FICA Taxes of the employee for tips reported.	2-28



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IRC § 7602(c)	Requires that we give taxpayers reasonable notice in advance of all contacts with third parties made regarding the determination or collection of their tax liabilities.	3-29
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### ***Cited Regulations***

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Treas. Reg. 1.61-2(a)	Wages, salaries, <i>commissions paid salesmen, compensation for services on the basis of a percentage of profits</i> , commission on insurance premiums, tips, bonuses (including Christmas bonuses), termination or severance pay, rewards, jury fees, marriage fees and other contributions received by a clergyman for services, pay of persons in the military or naval forces of the United States, retired pay of employees, pensions, and retirement allowances are income to the recipients unless excluded by law.	3-97
Treas. Reg. 1.132-5(o)	Defines who is a full-time salesperson, and what qualified automobile demonstration use is.	3-73
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Treas. Reg. § 1.471-1	Consignments of merchandise to others to sell are not sales since the title of merchandise remains with the consignor	2-15
Treas. Reg. § 1.471-8	Authorizes the use of the retail method of estimating the cost of inventories.	2-20
Treas. Reg. § 1.472-8(e) (3)	Authorizes the inventory price index valuation method.	2-22
Treas. Reg. 31.3508-1(a)	For Federal income and employment tax purposes, an individual who performs services after December 31, 1982, as a <i>direct seller</i> shall not be treated as an employee with respect to such services, and the service-recipient shall not be treated as an employee with respect to such services.	3-97
Treas. Reg. 31.3508-1(c)	The term “ <i>direct seller</i> ” means 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 for resale by the buyer or any other person in the home or in some other place that does not constitute 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 in some other place that does not constitute a permanent retail establishment.	3-97

### ***Cited Revenue Rulings and Revenue Procedures***

<b>Revenue Rulings and Revenue Procedures</b>	<b>Chapter Section</b>	<b>Page</b>
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Rev. Rul. <b>67-107</b> 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	3-70
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Rev. Rul. <b>85-63</b>	Self-employment tax deduction	
Rev. Rul. <b>89-62</b>	Provides the proper methods of deducting the video/DVDs. It was held that "video/DVDs are subject to section 167 of the Code and may be depreciated in accordance with the straight line method over the useful life of the video/DVDs in the particular taxpayer's business. Alternatively, the income forecast method may be used." Section 168(f) (3) of the Code provides that section 168 does not apply to "any motion picture film or video/DVD tape.	3-23
Rev. Proc. <b>90-63</b> , <b>97-37</b> , <b>98-39</b> and Rev. Rul. <b>89-23</b>	Package Design Cost - stating that these costs are capital in nature and depending upon the election a taxpayer makes, are recoverable over four or five years.	4-20
Rev. Proc. <b>92- 97</b> , 1992-2 C.B. 510 and Rev. Proc. <b>92-98</b> , 1992-2 C.B. 512.	If the dealer buys insurance, the income and expenses should be reported accordingly	3-63
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