



Market Segment Specialization Program



Auto Body and Repair Industry

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Auto Body/Repair Industry

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Introduction

This guide was developed by members of the Market Segment Speciality Program in Los Angeles to familiarize agents with some of the practices prevalent within the auto body and repair industry and share information on issues encountered during the study of this business segment.

All of the examinations included in this study were conducted in the Los Angeles basin and commentary reflects this location. State laws and local ordinances in other areas will differ, particularly in the areas of emissions and certification controls, sales tax applicability, and state tax reporting. Bird dog fees, towing, and dealer incentive payments may also be regulated. It is, therefore, important for the examiner to become familiar with local restrictions and compare them to those in the Los Angeles area when evaluating the material presented.

Returns examined were selected based largely on gross income, taxable income, and ZIP Code. Body shops were selected initially and represent the bulk of the returns examined, though several general auto repair shops were included later in the study.

Although the study included mostly C-Corporations, a few sole proprietorships were also examined, one of which was a referral from a check casher project. No towing companies, chains, franchises, or specialty services such as brake, muffler, or transmission repair facilities were included in the study.

The examinations undertaken spanned 20 months, including an initial transition period with a few returns remaining in inventory at this writing. This guide was written based on the knowledge of the industry gained over that period and cannot be regarded as all inclusive. (More information regarding other industry segments has continually surfaced and new or anticipated legislation will undoubtedly influence some established practices.)

The information presented is designed to provide the agent with a general familiarity with the auto body/repair industry before beginning an examination, and to describe some of the issues encountered in this study. The guide should only be used as a supplement to mandatory procedures and other available resources as well as the agent's own expertise in resolving cases involving the industry.

Chapter 1

THE NATURE OF THE AUTO BODY/REPAIR INDUSTRY

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.

Body shops are interesting in that 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. This often creates conflicts in determining whether shops are required to maintain inventories.

The industry is extremely competitive as a result of the influence insurance companies exert over auto body shops. Since insurance companies pay for most claims, they look for the most cost efficient businesses. A shop that is willing to use less expensive parts as opposed to factory originals will be preferred. This also applies to the labor rates that a shop charges. An insurance company will not hesitate to use a particular shop that charges \$27 per hour as opposed to one which charges \$28 per hour.

A body shop is also regulated by environmental agencies. Because of today's tighter air quality restrictions, the amount of hazardous materials it may emit 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.

Because of the above mentioned influences, competition is fierce in the industry. Accusations abound in the industry that payments are made to service managers in various dealerships to provide referrals. Shops have also been forced to cut costs whenever possible. These costs include employment taxes and worker's compensation insurance which are sometimes bypassed by treating workers as independent contractors instead of employees.

DESCRIPTION OF AUTO BODY REPAIR PROCESS

Repair/Replacement

Modern vehicles are being constructed with lighter and more flexible materials. On one hand lighter construction has made some aspects of the repair process easier because of the quick replacement process. On the other hand, because of the lighter materials, vehicles are more susceptible to damage on impact at lower speeds.

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, Failure to do a proper alignment is often the cause of a vehicle "not feeling the same" after a collision.

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. Again, this makes the vehicle more susceptible to damage at lower speed impact as well.

In the sections 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 either the body shop, the insurance company, or an independent appraisal company. The major source of information from which estimates are prepared is 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.

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.

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.

DIFFERENCES BETWEEN BODY AND REPAIR SHOPS

Because most of the businesses examined were auto body shops, these receive the most emphasis in this package. There are both similarities and differences between body and repair shops, some of which are shown below:

| | Body Shops | Repair Shops |
|----------------------------|---|--|
| 1. Insurance: | Auto body is mostly reimbursed by insurance companies. | Repair shops have some insurance work but most of the costs are paid by the owner of the vehicle. |
| 2. Suppliers: | Body shops buy parts primarily from dealerships. | Repair shops buy parts from dealership but frequently buy bulk parts from other suppliers at lower costs and may also stock items such as batteries, etc., on consignment. |
| 3. Order Size: | Body shops generally buy what is needed for a specific job but may stock some paint materials and small supplies. | Repair shops often order common parts in bulk as well as lubricants and fluids. |
| 4. Customers: | Body shops see their customers far less often. | Repair shops are likely to have a steady clientele and a lot of repeat and family business. |
| 5. Repair Order Documents: | Body shops usually use estimate forms with their repair orders. | Repair shops do not use the estimate forms seen in a body shop. |
| 6. Labor Charges: | Body shops generally charge a different rate for metal, paint, and frame labor. | Repair shops charge a flat rate for mechanical labor which is usually billed at a higher rate. |
| 7. Salaries: | Body shops sometimes pay all or portion of their staff on a based percentage of labor billings. | Repair shops nearly always pay an hourly wage. |
| 8. Inventory: | Body shops generally have work-in-process but little parts, materials and supplies inventory | Repair shops usually have less work-in-process and stock parts, materials, and supplies. |

Chapter 2

DOCUMENTS AVAILABLE

INTRODUCTION

The records kept by auto body and repair shops are generally neither elaborate nor complex. Most function as closely held small businesses with virtually no internal controls in place and little on site accounting supervision. Larger shops may employ some clerical help but often smaller establishments simply submit their check stubs and a stack of repair orders and/or their banking records to an outside accountant on a monthly or quarterly basis for posting and preparation of the accounting records and tax returns. The source documents may be maintained in a file or a carton or trashed, depending on the inclinations of the owner/operator.

GENERAL BOOKS AND RECORDS

An auto body shop will not generally have an elaborate set of books and records regardless of the accounting method used (cash or accrual). There will usually be a general ledger, a cash disbursements journal (or a combination of the two), a sales, and a cash receipts journal. An accounts receivable schedule may also be available.

The only distinctive journal which was encountered fairly consistently was the sales journal which will usually break sales down into the following categories:

1. Parts/Paint/Material sales
2. Labor Sales: Further break down will be metal labor (body work), paint labor, and frame labor
3. Sublet Charges
4. Towing Charges
5. Storage Charges
6. Sales Taxes

For smaller businesses there may only be single entry disbursement journal along with a listing of the sales for the month or a listing of the bank deposits if that

is the method used to record sales. In the latter case, a schedule of taxable versus non-taxable sales and sales tax inclusions should be available.

Other records may include payroll journals, sales tax returns, employment tax returns, Form W-2 statements, and Form 1099 statements. Less often there may be inventory records.

SPECIFIC DOCUMENTS

In performing an effective audit, it has been noted that many documents beside the usual purchase invoices, canceled checks, etc. are helpful in developing issues. These documents have been useful in developing inventory and income adjustments.

1. 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:
 - a. Insurance Company - Name, address, and telephone number of specific office handling the claim.
 - b. Date of Estimate - This date may be important in determining when the vehicle was actually brought in for inspection.
 - c. Date of Loss - Date vehicle was in the accident
 - d. Vehicle description - Vehicle type, model, year, identification number, license number, and mileage when brought in.
 - e. Customer name and whether that person is the **claimant** or the **insured** party. An address and phone number may also be listed.
 - f. Part description - Details whether the part fits on left or right side of vehicle, front or rear, and the specific name.
 - g. Part Number assigned by the manufacturer.
 - h. Suggested retail price of the part.
 - i. Allowed labor hours to install the part.

- j. Paint materials, their cost, and the allowed labor hours.
 - k. Sublet expenses such as mechanical repairs, glass replacement, anticipated costs, and allowed labor hours.
 - l. Towing and storage charges.
 - m. Sales Tax on parts and materials.
2. 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:
- a. Customer Name, address, and phone numbers.
 - b. Repair Order Number - Repair orders are usually sequentially numbered and may be used as a basis for recording the sales.
 - c. 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.
 - d. 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.
 - e. 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.
 - f. Sublet Charges - Mechanical repairs, glass replacement, tire replacement, etc.
 - g. Labor Charges - Repair Orders will usually list only the final totals and omit the actual hours worked or allowed.

- h. Towing Charges - Usually listed as a separate category.
 - i. 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.
3. Supplements: Supplements can be written on either 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 examined have been found to have the following information:
- a. Customer Name
 - b. Date supplement was either written up or approved.
 - c. Vehicle description.
 - d. 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 is often a significant time lag between receipt of the original insurance check and the supplemental payment.

4. Sales Invoices: In some cases, a sales invoice may be prepared for the customer which records all charges separately. For instance, parts, labor, and sales taxes may appear as three separate items. This method is often used by companies that do not have the storage space or who choose not to keep their repair orders and estimates on file. Needless to say, this makes it more difficult to trace parts purchased and other costs from the vendor invoice to a specific job.
5. 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 GUIDE

The Mitchell Guides and Mitchell Software now available provide information which an auditor may not require during the course of an audit since it often duplicates that provided by vendor invoices. It is, however, one of the primary tools of the industry so he or she should understand how the reference works.

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.

As explained above, the Mitchell Guides are essential for both auto body shops and insurance companies to prepare estimates in a quick and efficient manner.

In the event they are needed for reference, the auto body shop will usually have copies. Certain years may also be maintained at the local library.

ORGANIZATION OF RECORDS

Auto body shops usually employ relatively simple record keeping systems. Some knowledge about how the records are maintained, however, will save an examiner time by indicating HOW to ask for the essential information.

As with any industry, the organization of the records differs with each specific taxpayer. But many shops use similar systems. It is important to identify how the records are organized since the nature of the examiner's request will depend on the method used. The most frequently encountered systems are discussed below:

Current Jobs: Auto Body shops usually maintain current jobs in folders (job jackets). The information contained will include the estimate 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.

Once the job is completed, the taxpayer has a number of choices as far as filing the above information. In some cases, all of 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. In this case use of normal sampling techniques by the examiner is very difficult.

More often, the taxpayer 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. Although not the most efficient way of organizing records, it provides the examiner with an opportunity to probe more thoroughly.

Chapter 3

INITIAL INTERVIEW/TOUR OF BUSINESS

INITIAL INTERVIEW

The quality of the initial interview and the observation of the business premises will affect the overall success of the entire examination. The questions asked should generate an understanding of the background of the taxpayer, a familiarity with the operation of the business, an understanding of the accounting system, and a determination of who holds responsibility for the records. The positions held by the shareholders in the case of a corporate taxpayer also need to be evaluated.

Planning is essential to ensure a successful interview. A good pro-forma may be consulted as a guide in constructing a questionnaire or outline that covers basic information, but if used, it should be augmented to specifically relate to the business of the body shop under examination. Analysis of the return will undoubtedly produce questions unique to the particular business or year under examination that should be incorporated into your interview.

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.

Since this is a service operation, question the taxpayer 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 taxpayer 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.

When interviewing, it is usually best to be straightforward, asking specific questions and following up on incomplete or confusing responses in an

interested and professional manner. The taxpayer is likely to be more responsive in the early stages of the examination and can provide information that would be difficult to extract later.

It is not, of course, possible to anticipate all the questions that will arise later in the course of an examination, and follow up questions will be needed and should be submitted promptly as they arise.

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. Until it is understood how the books are organized and maintained, it does no good to proceed with the rest of the examination. It is important to know exactly how the records are kept and become familiar with any unfamiliar notations used by the taxpayer. This is particularly true of computer maintained records that may use many different sets of reference codes.

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.

1. When are initial estimates made? Is any charge made for them?
2. After the initial estimate is made, how are contacts made with the insurance company?
3. Does the estimate vary with the final bill?
4. Are repair orders used in sequential order?
5. When are the repair orders dated? (when written, authorized by customer, etc.)
6. What happens if a repair order is voided? Is it thrown away or retained? How many are voided?
7. 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?
8. When are parts ordered for a repair job?

9. How often is paint purchased?
10. At what discount do you purchase parts? (will probably vary with make of vehicle)
11. What are the labor rates charged for repair? (will vary depending upon type of work needed)
12. Do you supply loan cars? If so, do you get rebates from rental companies for the loaners?
13. When will a job be booked as a sale?
14. Do you have steady referrals from dealerships?
15. Are deductibles ever waived? What would be the circumstances?
16. Are liens ever placed on vehicles for sale or recovery of expenses?
17. If the taxpayer maintains inventory on the return, ask how the inventory has been computed and of what it is comprised.
18. How is the payroll determined for the repair staff? (hourly wage, salary, percentage of labor charge or a combination)
19. How is the repair staff treated - employees or independent contractors?
20. If taxpayer is a C-Corporation, what are the duties of the current shareholders?
21. What is the current percentage ownership of each shareholder?
22. Is there any family relationship between the shareholders?
23. Were relatives of the shareholders employed by the corporation?
24. How is officer compensation (salary, bonus, fringe benefits) determined?
25. 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, lessor, vendor, consultant)
26. Does the corporation own or lease vehicles assigned for the use of specific officer/shareholders?

TOUR OF BUSINESS

The tour of the business will usually follow the initial interview. If the initial interview has been a solid one, there should be an adequate basis from which to examine the premises. The tour is an opportunity to compare a visual interpretation of the business with the interview just received.

A typical auto body shop will usually have a parking area where estimates are made for 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.

As stated above, the tour should visually confirm what was learned during the pre-audit and initial interview. For example, if the taxpayer has not shown any inventory on the return, are there major parts lying around the premises waiting to be installed? Does the storage area for paint hold a couple of cans of paint or 50? 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. The taxpayer may actually still be deducting depreciation although use has been discontinued.

If the taxpayer has stated that the workers are independent contractors, notice if they are wearing uniforms of the taxpayer. Are they utilizing the major equipment provided by the taxpayer? Are they actually working on the premises of the taxpayer? If conditions have not changed since the year of audit there may be a potential issue.

Take a look at the size of the lot and any adjacent areas which may not appear to be related to the taxpayer and note the addresses. In reality, the taxpayer 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. If so, this should show up as other income or a credit to rent expense.

Ask the taxpayer to explain the repair process from the tear down process to the final drying of the paint. Usually, officers or principals are more than happy to share their business expertise and explain why they are

superior to the down the street. With an adequate understanding of the repair process, the documentation reviewed during the audit may be easier to interpret.

The above listed considerations and issues are only a few of the many that may arise with a good tour of the business. The important point here is to emphasize that the examiner should be alert to potential issues and conflicts with the taxpayer's statements.

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Chapter 4

BALANCE SHEET ACCOUNTS AND M-1 ANALYSIS

INTRODUCTION

The audit of an auto/repair shop should include at least an inspection of the balance sheet of the company. Audits of the balance sheet have revealed transactions such as improper accruals and shareholder owned assets being maintained by the business. This section will not go through all the balance sheet audit procedures as there are many training manuals covering this topic. However, some of the issues which have occurred in the auto body/repair shop industry will be highlighted.

COMPARATIVE REVIEW

One of the package audit requirements is to inspect the prior and subsequent years returns and one of the steps which is recommended in meeting that requirement, is a comparative review of the balance sheets for the respective years. On one case, the examiner did an analysis of the 9002 and 9102 years and noted several potential issues.

The first issue involved the Other Investments account on line 9 of the 1120 balance sheets. The **ending** balance for the 9002 year listed the balance as \$133,000. The **beginning** balance for the 9102 year listed the amount as \$70,000, a decrease of \$63,000. The examiner later determined that this decrease was due to three classic vehicles 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. However, corporate costs were involved in the restoration of the classic automobiles.

On the same balance sheet under Buildings and Other Depreciable Assets, the **ending** balance of the account for 9002 year was listed as \$112,298 with an accumulated depreciation balance of \$69,649 for a net balance of \$42,649. The 9102 **beginning** balance showed an assets amount of \$95,627 along with an accumulated depreciation balance of \$52,978 which still resulted in a net figure of \$42,649. In this case, a fully depreciated vehicle registered to the shareholder was taken off.

In another unusual situation, the balance sheet per the 1120 had ending balances but no beginning balances. However, when the books were examined they revealed that all the accounts had beginning balances. In this case, a business which originally had two separate locations and two shareholders had eventually encountered personality problems. The two shareholders split the two locations into two separate businesses via a reorganization. Further analysis by the examiner revealed that during the reorganization shareholder loans were forgiven and will result in a taxable transaction to the shareholder.

In another instance, the taxpayer had maintained a reserve for doubtful accounts which was still on the balance sheet. Authorization to use such a reserve was repealed the Internal Revenue Code but was never counted back into income by the taxpayer, in any one year or as an IRC section 481 adjustment.

CASH ACCOUNT

Analysis of the cash account has produced several routine adjustments along with some unusual situations, some of which are described below:

1. **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.
2. **Cash Receipts:** In one case the taxpayer presented a repair order which had selected receipts "whited out." These receipts were primarily supplemental payments. When the examiner requested an explanation of the white-out amounts, the taxpayer stated that this was an embezzlement situation whereby the former secretary would collect the checks, fraudulently endorse them and embezzle the funds. These amounts were never included as income in the books. Although the taxpayer will be allowed an embezzlement loss in the year of discovery, this nonetheless aroused great suspicion on the part of the examiner.
3. **Supplemental Payments:** In one case, the taxpayer recorded their sales based on the final repair orders which listed the income to be received from

the customer's insurance company. In several cases, supplemental work was required afterwards, which meant that a separate repair order was prepared. During the last month of the year, the taxpayer would record the initial income as stated on the original repair orders but would ignore 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. When questioned about why the supplemental payments were not recorded with the original repair order, the taxpayer responded that supplemental payments were not assured of being paid. (In this case, the supplemental payments were almost 100 percent guaranteed of being paid since the insurance companies approved them in the first place.) In this situation, the accrual basis taxpayer 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.

INVENTORIES

See Cost of Sales Section for discussion of inventories.

BUILDING AND OTHER DEPRECIABLE ASSETS

As mentioned above, a comparative analysis of the balance sheets for prior and subsequent years may reveal assets dropping off either by being sold or distributed to shareholders or partners. In other cases, an actual analysis of a fixed assets schedule may reveal the personal assets of the shareholder or partner listed on the corporate or partnership balance sheet. Further development may reveal that these assets are being financed by the corporation or partnership. In addition, expenses incurred to maintain these assets may be paid them as well.

In one case, an examiner encountered a boat which was listed on the fixed assets schedule but not included in the total value of the assets per the tax return. The boat was registered to the corporation but not depreciated and expenses for maintenance were not paid by the corporation. The boat was used by the shareholders for personal trips as well as entertaining service managers. No corporate adjustments were made

but dividends were assessed to the shareholders for fair rental value.

In another case a corporation maintained a resort property. The corporation paid the principal and interest on the mortgage and expenses for it's maintenance. In some cases the expenses were deducted by the corporation and in others they were booked to the shareholder loan account. This asset was eventually transferred to the shareholder and taken off the books. In this case, the property was booked to the asset account after the beginning of the year and was taken off before fiscal year end and thus never appeared on the 1120 balance sheet.

OTHER RECEIVABLES

In one case an examination of the employee advances account revealed 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.

In another case employee advances were simply transferred to salaries and wages and, again, never accounted for on the employment tax returns.

LIABILITY AND SHAREHOLDER'S EQUITY

Accounts Payable: In one case, the corporation was making improper accruals at the end of the year for purchases of parts and paints. Although this entry reversed itself out in the subsequent year, it materially misstated income for the year of accrual.

TREASURY STOCK

In two cases, stock repurchases have been encountered. Once, the transaction was handled appropriately with the sale being properly reported by the shareholder. In another situation, Treasury stock was repurchased from an attorney which resulted in a \$50,000 gain. The gain was properly reported by the attorney but it is not known at this time how the attorney received the shares in the first place.

SCHEDULE M-1 REVIEW

If the taxpayer is a corporation, the M-1 reconciliation should be reviewed for possible issues. Items such as the 20 percent reduction for business meals, officer's life insurance, traffic and parking tickets, (this can be quite substantial for body shops which utilize public parking for vehicle placement), and state income taxes are the usual items which should appear on the M-1 reconciliation.

In one situation, the state income taxes were missing from the reconciliation. Under present California law, the tax for the first year a corporation commences business after 1971 is a minimum tax prepaid upon incorporation. The second year's (tax year) tax is measured by the first year's income and prepaid during the first year (income year). The franchise tax continues to be prepaid in this manner until dissolution.

For Federal tax purposes, the franchise tax is deductible in the tax (second) year, not in the income (first) year. For financial accounting purposes it is deducted in the income year, or the year in which it is prepaid. Thus, the Federal tax deduction on the 9112 corporate return should represent the franchise tax prepaid and deducted on the books in 9012. The 9112 prepayments cannot be deducted until 9212. This timing difference requires an M-1 adjustment, which can be significant when there are differing tax rates and/or income fluctuations as in the case cited. Consult Revenue Ruling 79-410.

NOTE: The Los Angeles District applies RR-410 prospectively only for many corporations. All corporations whose initial year ends after December 31, 1979, are expected to accrue as described above, however.

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Chapter 5

SALES

INTRODUCTION

Auto body repair shops generate business income by providing and selling parts and services to the customer and the rebilling of subcontracted or sublet materials and services. Additional income may be generated by some shops through the purchase, repair, and sale of salvage vehicles.

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 to paint 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 judgement about what needs to be replaced and what does not often leads to substantial variation in quoted and approved repair costs. The estimates below, provided by a recent claimant, 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.

| | Shop #1 | Shop #2 | Shop #3 | Insurer |
|----------------------|----------|-----------|-----------|-----------|
| Parts: | | | | |
| Front Lamps Assembly | \$ 61.73 | 61.73 | 81.82 | 61.73 |
| Front Fender | 159.17 | 159.17 | 150.60 | 159.17 |
| Front Bumper Cover | 32.43 | - | 30.68 | 32.43 |
| Splash Shield | 29.95 | - | - | 33.85 |
| Molding - Protective | - | - | 22.98 | - |
| Front Bumper Cover | - | - | 219.05 | 231.53 |
| | ----- | ----- | ----- | ----- |
| Parts Total | 283.28 | 220.90 | 505.13 | 518.71 |
| | ===== | ===== | ===== | ===== |
| Labor: | | | | |
| Sheet Metal | | | | |
| Hours | 8.1 | 15.3 | 17.0 | 8.0* |
| Rate | \$28/hr | \$28/hr | \$18/hr | \$26/hr |
| Total | 226.80 | 221.40 | 198.00 | 153.40 |
| Refinish (Paint) | | | | |
| Hours | 4.4 | 12.3 | 11.0 | 5.9 |
| Rate | \$28/hr | \$18/hr | \$18/hr | \$26/hr |
| Total | 123.20 | 221.40 | 198.00 | 153.40 |
| Mech. (Frame) | | | | |
| Hours | - | 1.5 | 1.0 | 1.0 |
| Rate | - | \$45/hr | \$45/hr | \$35/hr |
| Total | - | 64.50 | 45.00 | 35.00 |
| Sublet: | | | | |
| Paint Materials | 79.20 | - | - | 88.5 |
| Cover Car | 10.00 | 10.00 | - | 10.00 |
| Wheel Alignment | 65.00 | - | - | - |
| Undercoat | 8.00 | - | - | - |
| Wash & Wax | - | 25.00 | - | - |
| Hazardous Waste Fees | - | - | 26.88 | - |
| Sales Tax: | 31.39 | 36.49 | 45.70 | 50.92 |
| | ----- | ----- | ----- | ----- |
| Total | \$826.87 | \$1009.69 | \$1296.71 | \$1064.53 |
| | ===== | ===== | ===== | ===== |

* Initial estimate omitted the cost of a front bumper cover and included only 1 & 1/2 hours of sheet metal labor.

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.

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 distinction 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. It is not a major category of income or expense since the vehicle to be repaired is often drivable, or the fee may be waived under a club service agreement. 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.

Estimate Fees

Estimates are usually made without charge and if billed, along with storage and towing, may indicate that the shop is engaged in unethical practices.

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, and a few filings may be seen in the books of a company under examination. 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 reputable shop, but one of the body shops examined filed 80 to 90 per year. The implications of such multiple filings are discussed in the Expenses section, but income from storage fees on redeemed vehicles and sales can be expected.

Sales Tax

California sales taxes are levied on the seller of parts and materials, though they are passed on to the consumer. The written final estimate made is the basis for computing the tax due unless it is formally amended. No tax is computed on services, but any portion of a sublet job that constitutes materials and parts is also subject to tax. For example, if a windshield is replaced, the cost of the glass is

taxable and the labor to install it is not. In practice, tax is rarely computed on sublet work.

OTHER INCOME SOURCES

Rebates and Refunds of Expense

Car rental agencies commonly rebate or "kickback" a portion of the fees paid by the repair or body shop or customers referred by them. Nearly every shop examined in the course of this study either reported income from this source or decreased the expense account by the amounts received.

Insurance dividends and cancellation adjustments are often treated as an expense account reduction but may be reported as miscellaneous income, especially if applicable to a prior period expense. So-called dividends are commonly paid on worker's compensation policies and cancellation adjustments are made when a company vehicle is disposed of or a new carrier engaged.

Vendors often issue checks for merchandise returns when the shop does not maintain an account. In some cases, a refund check issued for larger items even if a credit line is maintained. These refunds are usually reported as a credit to the expense account rather than income.

Sublease of Premises and Equipment

Two of the establishments examined sublet a portion of their leased quarters. In one case they also billed for the use of office equipment and utilities. The payment was treated as income in one instance and a reduction of expense in the other.

Advertising Space

A billboard situated on the business site will generate income to the owner, which may be the proprietor or corporation.

Old Checks

In nearly every business, some checks issued are never cashed and those over 6 months or a year old are usually written off. They are income in that they represent an amount deducted previously that has not been paid and because of this, may be used as an offset to the appropriate expense account. These were

previously mentioned in the Balance Sheet Section of this guide.

Other Sources

Repair shops may also sell gasoline or issue smog certificates, although none of the businesses examined during this study did so.

Dealing in smog certificates is a current abuse area according to a recent interview with Bureau of Automotive Repair officials, who believe that large illicit profits, made by selling certificates for untested vehicles, go unreported. This is said to be accomplished by either understating the charges or omitting certificates sold when accounting for income. The number of certificates issued to any location should be traceable through the Department of Consumer Affairs.

Gasoline sales have been intensively studied and the Gas Retailers MSSP guide is available which deals with the problems encountered. It should be consulted before proceeding with the examination of a gasoline service station.

ACCOUNTING FOR SALES TAXES

The State of California levies the sales tax on the retailer, who is liable whether he or she reimburses himself or herself through the customer or not. The tax is payable to the state in the reporting period in which the sale is made, without regard to any receivables generated and is based on costs as stated on the repair order. If a bad debt occurs, adjustment is made at the time the debt is written off for income tax purposes. For Federal tax purposes, sales tax collected is properly included in gross receipts and deducted as an expense.

A cash basis shop should, therefore, be on an accrual basis for sales tax and no adjustment to repair order charges from estimates for taxable items made, even if a concession is granted to a customer. Any supplemental repair orders should also be included with that originally issued, regardless of the payment date.

Ideally, the sales tax returns and records would be an excellent source of information for use in changing a cash basis reporter to accrual. Unfortunately, compliance with the sales tax regulations is no better than compliance with income and employment tax regulations and a study of copies of the sales tax

returns filed often reveals little more than the amount of tax actually paid over. In this respect a comparison of the amount collected, usually available in the cash receipts records, with the tax paid may prove interesting.

In the case of most cash basis taxpayers, the sales tax returns are also on a cash basis. Concessions made to customers often reduce the taxable portion of sales and under-collection of tax is adjusted by journaling parts and materials income over to labor sales. Seldom is tax computed on sublet charges of any kind.

If the taxpayer is manipulating his or her sales tax returns, they are of little use in verifying income, but they are indicative of the taxpayer's respect for and compliance with the sales tax laws and should raise doubts about his or her compliance in other areas.

If the taxpayer does not account for sales tax in the manner previously outlined, the taxpayer is likely to use one of two other methods observed. Either:

1. Sales will be posted to sales accounts by category as outlined, but omitting sales tax as an income and expense account. The sales tax will instead be credited to a payable account, or
2. Sales will be posted in full and the sales tax payments made to the state will be debited to the revenue account.

If the second method is used, it is more difficult to underreport income by the amount of sales tax charged but not paid over to the state.

Sales Tax Audits

Occasionally the California State Board of Equalization audits auto body and repair shops and makes an assessment, often agreeing to a monthly payment plan. These assessments have three parts: unpaid tax, interest, and penalties. The payment or payments made by the shops are typically deducted as tax expense, though they may not be fully deductible and may also be indicative of unreported income on the Federal return.

The reason for the assessment needs to be determined. If sales tax was computed on previously unreported sales, then it must be determined if the sales were reported for Federal tax purposes or omitted from reported income. If the sales were not reported and

the statute allows, the amounts can be added to income. No deduction for delinquent tax is allowable, of course, in the case of unreported transactions.

If sales subject to sales tax were reported but misclassified as nontaxable, it is necessary to determine if the tax was billed to the customer. If it was charged and the taxpayer accounts for sales net of tax, a deduction for the delinquent sales tax paid cannot be allowed as it would amount to a double deduction.

If penalties are assessed, no deduction is allowable for that portion of the assessment.

INDICATIONS OF UNDERREPORTING

Estimating Sales

If a magazine seller makes 25 cents on each dollar magazine sold, with full credit for unsold editions, one can determine sales with a high degree of accuracy by referencing purchases accounts.

The situation is not quite as routine in the auto repair business, but 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. One particular body shop examined paid

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. It is probably safe to double labor costs to initially estimate labor income in most instances. 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 under reported income, but there are others, some of which are:

1. The above percentages are invalid for this particular business, especially for labor.
2. Costs have been miscategorized.
3. Some labor costs are paid "off the books." This will make imputed income from labor lower.
4. There is a large unreported inventory variance.
5. Insurance fraud is present, making imputed parts sales lower if parts are billed but not supplied.

Once the examination is under way, the direct expenses can be categorized properly, if necessary, 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 another factor should be made.

Bank Deposits

Often sales figures are based on business account deposits and, if this is the case, that account probably requires little attention. A reconciliation of repair orders to deposits made and a check to ensure that returned items, if any, are included in receipts is adequate if there is an exact match.

When sales are reported based on a sales journal total of repair orders, a closer look at the bank records is appropriate. When total deposited funds are in excess of reported sales, adjusted for beginning and ending receivables, an explanation is certainly required. A reasonable explanation such as the deposit of loan proceeds may be forthcoming, or the reason could be

traced to unreported receipts. In one case included in the study, the owner of a small corporation failed to write repair orders or report any supplemental payments received over the fiscal year, but did deposit them in the business account.

When bank deposits approximately total the receipts reported in the sales journal, it does not necessarily indicate that the repair orders that are listed in the journal are the same as those deposited in the bank. If duplicate deposit slips are available, a comparison with sales as reported in the sales journal is simplified. It is more likely that they will not be available, and in that case, a few quick checks can be made to test the sales journal. Returned checks should appear in the cash receipts journal or a deletion shown if they are repeatedly returned. Repair orders which may be offered in verification of a specific item should also be traced to sales. When credit cards are accepted and repair orders show the method of payment, a comparison with credit card deposits can be made. Small deposits, if present, may be single jobs and traceable back to the sales journal.

If there appears to be deposited items or repair orders that do not appear in the sales journal or perhaps in cash receipts as an offset to expense, it may be advisable to issue a summons and compare the deposited items with the reported sales. This can be done on a limited basis, sampling the account, if desired.

In the case of one repair shop, information was secured from a check casher indicating that the owner negotiated many checks received in the course of his business. A sales journal roughly approximated deposits made to the sole business account. When a schedule of known cashed checks was compared with the receipts shown in the sales journal, approximately 45 percent of them appeared to be reported. Five returned checks were not in the sales journal and a repair order presented in verification of a purchase and partial refund could not be traced to reported receipts. Only a few small deposits were matched to receipts reported. It, therefore, appeared that the taxpayer cleared the sales journal based on bank deposits, which were monitored by his accountant, and the adjustment to income should not be based merely on the undeposited cashed checks. A summons was necessary to determine the amounts of cash that were redeposited and the total deposited receipts unreported.

The summoned deposit slips showed there were no cash deposits made during the years examined and that

deposited checks were only partially listed in the Sales Journal. The repair orders from reported sales indicated the payment method and a comparison of listed credit card charges to credit card deposits showed that only a fraction were included in sales.

Many Sales Journal listings were still untraced and third party contact will be necessary to determine if the checks were cashed at another place or deposited in another account. Once this is accomplished, those records can be summoned to determine the amount of additional unreported sales. Prior to this step, the adjustment secured includes the total of:

1. Cashed checks not included in the Sales Journal
2. Deposited checks not included in the Sales Journal
3. Credit card sales in excess of those included
4. Other Sales Journal listings not deposited or cashed above, This would include listed cash sales and probably represents part of a substantially larger pool of sales, that is, of all checks deposited in another account, it is probable that only a fraction are presented in the Sales Journal.

All personal banking records, including brokerage and money market accounts, also need to be examined for the sole proprietor, partners, or shareholders and other indirect methods can be employed in the case of proprietorships and closely-held corporations.

One word of caution when comparing bank deposits to reported sales; be sure to consider sales tax receipts when the taxpayer's summary of sales omits them from the reported gross.

Repair Orders

These are usually, but not always, numbered and used consecutively just like checks in a checkbook, but rarely filed in that manner. 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. It may mean only that another set of repair orders is also in use. If repair orders are not numbered, a schedule of the number written by date may provide indications of omission, especially in a repair shop.

Breakdowns of Sales and Costs

This kind of analysis is more effective if the books are kept on an accrual basis but can be enlightening for cash basis reporters too, especially those who pay workers on a percentage basis. Wide variations in direct costs as a percentage of sales can be seen when income is unevenly underreported. Some variations can be expected however, when bills are not paid promptly or workers are paid a straight salary during slow periods. Large unreported or fluctuating inventories can also distort the cost percentages.

Checks to Check Cashiers

Occasionally a customer's check, negotiated at a check casher, is not honored by his or her bank. The taxpayer is asked to replace the check and writes a check to the check casher or to cash (with the casher's endorsement). If you come across such a check it may help to contact the check casher for any transaction records maintained. A summons may be required.

Such checks were seen in the drawing account of a sole proprietor and the returns and allowances account of a small corporation.

Cash Transaction Records

If the taxpayer is cashing checks in multiple amounts, Cash Transaction Records (CTRs) may be filed by the bank used, or even by the check casher used. Although one does not think of check cashing establishments as CTR filers, and many may not file them, we recently came across some reporters.

Large amounts of cashed checks can of course, be indicative of unreported sales and/or being a cash payroll.

OTHER INCOME ISSUES

Held Checks

Cash basis establishments that base sales on deposits made to the business account often delay depositing year end receipts until the beginning of the subsequent year. This delay is not always intentional, or necessarily done for tax purposes, and any distortion caused may be corrected by a year-end journal entry recognizing deposits in transit as income in the current year. If the checks held are not so accounted for, a deferral of income results which can amount to a few days or a few weeks worth of business proceeds. Examination of bank deposit dates and amounts will generally indicate when checks were held over for deposit in the following year. If the payment received date is shown on the repair orders, they may be matched against duplicate deposit slips, if available, to verify the accuracy of accounting for yearend checks. Otherwise it may be necessary to summons the bank for items deposited early in the subsequent year if amounts appear to be significant. Nonrecognition of income on the appropriate date can also stifle attempts to accurately recreate both income and receivables.

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 co-payment 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.

One taxpayer actually marked the repair orders' deductible line "paid" with the date, then whited-out the record on his copy and altered it to show the amount was waived. Held up to the light, they were entirely readable from the back.

In lieu of such a convenient record, 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

A repair shop examined understated income somewhat by failing to report cash payments received. The number was not large since most customers paid by check or credit card, and would probably have gone undetected had the taxpayer not maintained detailed duplicate deposits slips, attaching the appropriate repair orders. Income was reported based on the bank deposits. The duplicate deposit slips, save one, corresponded to the bank deposits shown on the statements, though the posting date was often delayed. The one duplicate total that differed from the lesser actual deposit made included some cash which represented the difference. No other deposit slip included any cash amount, although some cash will be received in any repair business and many body shops insist on payment by a certified or cashiers check or cash.

In this case, all repair orders were available, including voided numbers, and it was not difficult to determine the cash payments made. If no repair order has been written, or voided orders were claimed but not retained, the amount of understatement would be difficult to pinpoint unless it was substantial.

Cashed Checks

A small Schedule C repair shop was picked up for audit as the result of a referral from a check casher project conducted by the Compliance Group in Los Angeles. The examination was opened for 2 years and information on checks cashed at a specific check cashing business was available for 11 months of the first year, after which the check casher ceased business.

The taxpayer did not base gross receipts on bank deposits, but might as well have done so, since

deposits were nearly equal to gross reported sales and his accounting firm compared the two monthly.

One would imagine that the taxpayer simply cashed checks representing some repair orders and scheduled those he deposited in the bank, but this was not the case. About 45 percent of the cashed checks were scheduled in the sales journal, leaving 55 percent or just over \$100,000 unaccounted for in the first 11 months under examination.

Other items were unusual too. Several returned checks were noted in examining the bank statements but no repair order could be located for some of them. A payment was deducted that was shown to be a partial refund of a prepayment for a customer ordered transmission to be installed at the shop. The cost of the transmission was paid by the shop and deducted but the exchanged check was not included in income.

It appeared that the taxpayer was letting the tail wag the dog by tailoring his receipts journal to his bank deposits. The deposit tickets only were summoned for the entire period to keep processing costs down initially. Deposited items could then be paired with those reported and cash deposits or redeposits determined.

Inspection of these records revealed that no cash at all had been deposited in the 2-year period, either from cash sales or redeposit of funds received from cashed checks. Though the case is in process at this writing and the analysis of the record is still incomplete, many repair orders listed in the sales journal are neither deposited or among the checks cashed at the data source. Additional summons information will be needed to confirm the income items and some third-party contacts may be necessary to identify the replacement check casher.

Some of the unreported funds in this case may have been used to pay a part of the payroll in unreported cash. The balance is most likely related to supporting the taxpayer's lifestyle, (which included large bank and brokerage accounts). Although there was information available regarding cashed checks in this case, other indications of underreporting were also present. It may not always be obvious if the taxpayer has cashed checks, but when a situation such as the one described is encountered, follow the trail it leaves (backwards) to the source. This might be accomplished in the following manner:

1. Summons a month of deposited items and/or deposit tickets.
2. Note any deposited items not included in the sales journal.
3. Note any repair order listed in the sales journal not deposited.
4. Contact the customers located above by using the name and address on the repair order and request all cancelled checks written to the business and not deposited to the business account.
5. If the check was cashed at a check casher, their records can be summoned. If there is another bank account, or checks were cashed at a bank, the bank record can be summoned.

Journal Entries

Adjusting journal entries affecting income and expense accounts should always be examined carefully to ensure their propriety. Errors can and do occur and are occasionally subject to less than diligent review. While not commonly encountered, one of the largest income adjustments discovered among the cases examined in this study was the result of such an erroneous journal entry and is discussed here for that reason.

The entry was made in the process of converting accrual basis books to cash basis for tax purposes. To effect the change it was necessary to adjust the revenue accounts for beginning and ending receivables and deposits and the expense accounts for inventories and payables. The tax provision and the retained earnings accounts then required adjustment based on the variations in the income and expense accounts.

The trial balance was done on a computer spreadsheet and included some unnumbered and untitled entries inserted at the closing. One such entry immediately followed unearned deposits, which were treated as current income for tax, but not financial statement purposes. The trial balance, in part, is illustrated as follows.

| | Beginning Balance | | Ending Balance | Total Adjustments | | Tax Balance |
|---------------------|----------------------|-----|-------------------|----------------------|-----|----------------|
| Accounts Receivable | \$195,000 | (a) | \$120,000 | (\$120,000) | (b) | \$ 0 |
| Unearned Deposits | (105,000) | | (55,000) | 55,000 | © | 0 |
| (Untitled Account) | - | | - | (300,000) | (d) | (300,000) |
| Provision for Tax | - | | - | (250,000) | (e) | (250,000) |
| Sales | | | (6,000,000) | (195,000) | (a) | |
| | | | | 120,000 | (b) | |
| | | | | (55,000) | © | |
| | | | | 300,000 | (d) | |
| | | | | 250,000 | (e) | (5,580,000) |

The credit balance in the untitled account (d) and the part of the provision shown (e), appeared on the balance sheet as part of other long term obligations. The beginning amount in the unearned deposits account, if recognized in the prior year for tax purposes, should have debited the sales account but did not. The result of the unusual entries made was to understate income by as much as \$550,000 for the year in question. There were no such debits to sales in the subsequent year, though the unexplained long-term liability remained on the books. Both the untitled account and the provision appeared in the same location on the subsequent trial balance, but closed to the retained earnings account.

Chapter 6

COST OF SALES

INTRODUCTION

Cost of sales for an auto body business will be the largest category of costs shown on the return. It encompasses at least three major costs categories which are:

1. Purchases
2. Labor
3. Sublet Expenses

It may also include inventory totals for the beginning and ending of the year. Because of the large dollar amount relative to the other expenses, cost of sales warrants special attention.

It should be noted that the following audit procedures are only suggestions and should not be considered as an all-inclusive approach. The examiner should always consider his or her own personal audit techniques gained from experiences which have proven successful in the past.

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 bondo, 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 lists price for paint, parts, supplies and other items. Vendors will normally provide discounts to auto body shops ranging from 15 to 40 percent of the retail price. If a taxpayer 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

The examiner should request the following if possible:

1. General Ledger
2. Disbursements and/or payables journals
3. Journal entries or accruals
4. Original Estimates: These documents may be prepared by the taxpayer 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 taxpayer 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 order.
5. 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.

6. 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.
7. Canceled Checks: A scan of endorsements can prove interesting for any expense account.

Purchases - Audit Procedures

Standard testing procedures provided by the Internal Revenue Manual sections 4231 to 5(10)(2) for cost of sales should provide sufficient audit coverage. However, the taxpayer's method of filing their records may require modification of the examiner's transaction selection process. Because these situations have consistently arisen, they warrant mention here.

1. Source documents maintained by customers. -- In this situation, the taxpayer 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.
2. 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 well be filed by customers. In contrast to the preceding situation, inventory test work is more difficult.
3. 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.

In one case, payments were made out to a business which was not one of the usual suppliers. The examiner followed up on this and discovered that the purchase was a used Mercedes which the shareholder was planning to fix up and resell at a profit. The vehicle was not subsequently sold but converted to a personal asset. In this instance it was determined that the asset was removed and booked to the shareholder's loan account. Although properly handled, this illustrates that the potential for personal expenses and/or unreported sales exists.

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 it's 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, wetblocking, application of the bondo, 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.

Labor: Records to Request/Examine

1. General Ledger
2. General disbursements and payroll journals
3. Journal entries and accruals
4. Employment Tax Returns: (Forms 940, 941, and DE-3 with employee quarterly summaries and payroll journal)
5. Form 1099 information return statements, if available
6. Canceled checks

Audit Procedures

Because of the rise in labor related costs such as worker's compensation, health insurance, and employment taxes, some taxpayers try to escape these costs by treating all or part of their labor force as independent contractors. The actual determination of whether individuals are employees or independent contractors will be discussed in more detail in the Employment Tax Section. However, initially, the examiner should be aware of certain signs which may indicate an employment tax issue.

1. During preaudit of the return, compare the employment tax deduction with the respective labor, wages, and salaries. For 1991, the rates applicable during the year will involve FICA of

7.65 percent, Net FUTA (For California) of .8 percent (On first \$7,000 only), and State taxes around 3.5 percent. Therefore, an estimate of around 10 percent (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.

2. 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. In some cases, the taxpayers converted 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.
3. If the taxpayer maintains a relatively organized accounting system, 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.
4. Examine the Form 1099 statements issued by the taxpayer. In some cases, Form 1099 statements were made out to "Adelphi's Autobody" or "Butler's Autobody." Several of these Form 1099 statements should arouse suspicion as it is unusual for auto body shops to sub-contract work out.
5. 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 taxpayer's business name on them. This indicates that they are representing the taxpayer. Then check the employment tax records to see how they are being treated.
6. In some cases, actual invoices are prepared by employees classified as independent contractors. Items such as telephone numbers and addresses should be checked carefully if listed on the invoices. If the addresses and the phone numbers

are the same as the taxpayer's then suspicion should be aroused.

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:

1. Tire Replacement: If a vehicle's tires were damaged then the body shop will sublet the vehicle out for replacement and wheel alignment.
2. Window Replacement: Replacement of glass or mirrors and tinting.
3. Detailing: Involves car washes, waxes, cleaning of the vehicle, and "scenting" the interior.
4. Pin stripping: Involves specialized painting or application of decals to the vehicle for enhancement purposes.
5. Upholstery Work: Replacement or recovering of seats.
6. 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 taxpayer. The purpose here is to make the examiner aware of the different type of costs incurred by the taxpayer.

For specific records to request/examine and audit procedures, see those listed under purchases.

INVENTORY

Many body shops maintain little or no inventory amounts on their tax returns. Discussion with various taxpayers revealed some insight. Many individual's concept of inventory involves parts and/or paint purchased and stored in advance of any particular job. The idea that parts purchased and attached to vehicles represents inventory never enters their minds. Another reason taxpayers may not maintain inventories is their belief that they are really a service business and not

a retailer even though they collect and pay sales tax on the parts and paint.

In some situations, it has been found that the taxpayer has a high dollar amount of parts either sitting around or installed in vehicles. This could result in a significant change in cost of sales depending upon what the taxpayer has stated on the return. If an auto body shop is on the smaller end of the scale, the question of materiality comes into play in inventory determination. Some points to keep in mind are whether the taxpayer has expanded operations since the original return, or whether they repair primarily domestic vehicles or foreign vehicles. (Foreign parts like those for the BMW and Mercedes, tend to be higher priced than Chevrolet or Ford parts.)

Paint and other supplies needed to restore an automobile are also often ignored for inventory purposes. Depending on the quality and quantity of the paint used, this can be a significant amount.

Inventory Requirements

Treas. Reg. section 1.471-1 states that 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. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale. A further requirement is that goods should only be inventory if title thereto is vested in the taxpayer.

Since the taxpayer makes a profit on the sale of parts ranging anywhere from 17.65 to 66.67 percent of the wholesale price (based on discounts of 15-40 percent), this meets the income producing requirements in the regulation. However, it is not required that a profit be made on parts sales for those sales to meet the income producing requirement of the regulations. Rather, if the cost to the taxpayer of the parts constitutes a significant percentage of the taxpayer's receipts, the test may be met. In *Wilkinson-Beane, Inc. v. Commissioner*, 420 F. 2d 352 (1st Cir. 1970), the court concluded that caskets used by an undertaking establishment in providing funeral services were an income-producing factor within the meaning of Treas. Reg. section 1.471-1 where the cost of the caskets constituted 15 percent of the taxpayer's cash basis receipts.

These parts are usually expensed by the time they are installed on the vehicle. If the job is either in progress or completed by yearend and the sale is not recorded until the next year, a mismatching of income and expenses occurs. In some cases, a vehicle which requires a long period of time to repair may have parts ordered throughout this period. If this period overlaps taxable years, then a mismatching of income and expenses certainly occurs.

It does not matter whether the business is an accrual or a cash basis taxpayer. If the sale of merchandise is an income producing factor, then inventories are required. In the case of *Wilkinson-Beane, Inc. v. Commissioner*, 420 F.2d 352 (1st Cir. 1970), it was established that a taxpayer was required to inventory it's merchandise despite the fact that it was on the cash basis method of accounting. In fact, the taxpayer was required to convert it's method to the accrual method because of the inventory requirements.

Another reason that taxpayers have posited as justification for no inventories is that they keep no merchandise on hand and only acquire parts to satisfy the requirements for a particular job. However, courts have not required on-hand items in order to require a taxpayer to have inventories. See, *J.P. Sheahan Associates, Inc. v. Commissioner*, T.C. Memo. 1992-239; and *Independent Contracts, Inc. v. United States*, 94-1 U.S.T.C. 50,135 (N.D. Ala. 1994).

Records to Examine/Request

1. Inventory Records, if available
2. Sales Journal
3. Original Estimates
4. Repair Orders
5. Sales Invoices

Audit Procedures

Audit techniques involved in inventory determination will be dictated by two primary questions:

1. Is inventory required?
2. If it is, how should it be computed?

Suggested Step 1: Inspect Return

It will not be unusual for the return to list zero inventory on the Cost of Sales schedule even with an accrual basis taxpayer. In other cases, constant and even amounts such as \$1,000, \$5,000, etc. will be listed as both beginning and ending inventory. These are strong indications that inventory levels are inaccurate.

Suggested Step 2: Walk Through of Business

Take a look around the business to see how large the lot is. If the lot can accommodate 40-50 vehicles in the various departments, chances are parts have been installed in some of them. Take a look at the lot for parts that are lying around the premises. Because there are usually no storage facilities, parts will be placed where ever there is space. In one case, a taxpayer who did not maintain inventory on the return had approximately \$3,000 worth of parts in his office alone.

Suggested Step 3: Determination of Title and Amount

The audit techniques required to answer the first question will depend upon the type of records the taxpayer has maintained and more importantly, **how** they are organized. The primary question to be answered is whether the taxpayer has expensed certain parts during the year which are still on the premises at the end of the year or in transit. This involves tracing the parts from the moment that they were purchased to the time they were considered sold.

Because the organization of the records plays a big role in the ease of the computation, the audit procedures are segregated by the way the taxpayer maintains their records.

Source Documents Maintained by Customer

As mentioned above, some taxpayer will maintain all source documents (estimates, repair orders, purchase and sales invoices) by customer. This arrangement makes it relatively easy to trace specific parts from the actual purchase to the sale.

The initial step is to determine which jobs in progress at the end of the year have expensed parts installed. This means examining customer sales which have been

booked in the subsequent period. A good starting point for test work is the first month's sales of the subsequent period. The sales journal should be obtained if maintained. Most taxpayers will categorize their sales by parts, labor, paint, and sublet categories. Those customers that generate parts income should be concentrated on. Once the customers have been selected and the packages pulled, it is a simple matter of examining those invoices for purchases made on or before the close of the taxable year. The amount recorded at cost will be the inventory amount. Since parts are usually purchased locally, there usually is no freight consideration. Overseas and out of state special order purchases are another matter.

Before the adjustment is proposed, the examiner should scan the customer package for any credit memos for returned parts. These will normally be attached to the original purchase invoice.

Purchase Documents Maintained by Vendor

In this situation, the purchase invoices are segregated by specific vendors and not by customers. Estimates, repair orders, and sales invoices are still organized by customer.

This situation means that the job will be a little more difficult. The problem arises when parts purchases cannot be directly traced to customer repair orders or sales invoices to determine whether they were booked by the end of the taxable year. Two alternative approaches may be taken, however, to estimate the amount of parts on hand at the end of the year.

Alternate #1. The first approach is based on an examination of subsequent year's sales to determine when the job was actually started. Using this approach, the examiner makes an estimate of how long the majority of jobs will take to complete. This may be done during the initial interview or it may be determined by examining repair orders during the year and determining when they were recorded as a sale. In this situation it is assumed that the examiner will have the repair orders, estimates, and sales invoices available.

Once a period has been determined as a cut-off, the taxpayer's subsequent period sales journal should be examined for transaction selection. Again, if the sales are broken down into parts, labor, or sublet

income, then those sales which have parts should be concentrated upon. The repair orders can then be requested for examination.

The next step is to determine when the job was actually started and when the related parts were purchased. If the specific job has the related estimate, repair order, and sales invoice all associated together, this should not be a problem. The repair order will usually have the date the customer authorized the work to begin.

Once the examiner has determined that a specific job was started before the end of the taxable year, he or she will need to concern himself or herself with the purchase dates of the parts. This is usually a problem since the repair orders will not list the dates parts are purchased. In this situation, the examiner must make an assumption that **all** parts listed were purchased before the end of the year unless proven otherwise.

The cost of the parts can then be added up to arrive at an inventory number. However, because the parts are usually recorded at retail on the estimate or repair order, the number must be adjusted downward to arrive at a parts amount at cost. The percentage discount is usually easy to arrive at since dealerships will list the cost of the part both at the retail level **and** at the wholesale level on their invoices. This allows enough data to compute the appropriate conversion percentage.

This number can be arrived at in several ways. The examiner can take an average of the part prices at wholesale versus the prices at retail. This job is made easier if the auto body shop specializes in one specific type of vehicle (German, Japanese, etc.) or uses the same source for virtually all parts of a given make of car.

If the repair order actually lists the dealer purchased from, a sample invoice can be pulled to determine what the dealer has listed as its retail cost versus wholesale cost.

Alternate #2. The second alternative is based on the vendor invoices. In some situations, the determination of when a particular job was started is not possible for the examiner. This occurs when repair orders and estimates are disposed of or destroyed once the job has been completed. Sales invoices may provide clues as to when job were completed but not when the job was started. In addition, sales invoices will usually list the parts sales as one lump sum.

In this situation, several assumptions are necessary based on the initial interview and follow up questions. The examiner must determine approximately how long a job will take from start to finish then assume that all parts are purchased at the beginning of the job. As an example, assume that average job will take 3 weeks from start to finish.

The vendor invoices should then be pulled for those parts which were received during the last month of the taxable year. Any invoices which list parts purchases falling within the 2-week period before the end of the taxable year can then be assumed to have been on premises at the end of the taxable year. In some cases, a cash basis taxpayer will have a credit line established with suppliers. If invoices for parts received in one month are not paid until the subsequent months, the subsequent month's invoices should also be inspected.

Inventory Listed on Return

Even if the taxpayer shows inventory amounts on the returns, it should be assumed that the amounts are correct. In several cases, taxpayers have stated that their inventory amounts are simply estimates based on a quick look at their lot or do not include specific items, particularly work in process.

Paint and Supplies Inventory

The examiner should also consider whether paints and supplies should be included as an inventory amount since this can result in a significant amount. This is especially true if the taxpayer maintains his or her own paint supplies and utilizes high grade paint. Several thousand dollars may be incurred for paint purchases at any one time. The examiner should balance this consideration with the materiality of the potential adjustment. If the levels of paint and supplies are minimal, then the examiner may consider passing the adjustment.

The procedures used to determine the amount of inventory on hand at the end of the year requires the judgment of the examiner. If paint purchases are made at the end of the month, then the amount of paint on hand at the end of the year will usually be the greatest. On the other hand, if the paint is usually purchased at the beginning of the month, then the amount of paint will usually be at it's lowest level at the end of the month. Once the examiner determines when the paint and supplies are purchased, the

proration of the paint can then be determined by questioning the taxpayer as to how many gallons they are allowed to spray by the EPA or AQMD.

CHANGES IN ACCOUNTING METHOD

Treas. Reg. section 1.446-1(c)(2)(i), states that when it is necessary to use inventories, the accrual method of accounting must be used with regard to PURCHASES and SALES unless otherwise authorized under the following subsections of the regulations. Because a change to the use of inventories may require that a cash basis taxpayer convert to an accrual basis, the examiner should be aware of the necessity to make adjustments in other areas. See Section on Changes in Accounting Method.

Chapter 7

EXPENSES

INTRODUCTION

Many of the accounts in this category are not necessarily unique to the auto body and repair business and some expenses that may appear as "Other Expenses" on a particular tax return are discussed in the "Cost of Goods Sold" section or in the "Employment Tax" section of this guide.

Included below, are expense categories where significant areas of abuse were found; either in the sense that adjustments were discovered on a large percentage of the returns examined, or in that large dollar adjustments were produced when the issues were identified and pursued. Additional accounts have been included because their examination may be of assistance in resolving other issues. None of the summaries are intended as a comprehensive guide to the examination of an issue, however.

AUTOMOBILE EXPENSE

Personal use of business vehicles was an area of abuse found on many returns examined. Auto expense related deductions can also overlap many other expense categories including interest, tax and license, insurance, equipment leasing, and depreciation.

Company and personal vehicles are often used to pick up parts and customers or make estimates at another site. Unless they are garaged at the business location, they are also used to commute, vacation, pick up the kids from Little League, and run other household errands. When multiple vehicles were owned or leased by a company, it was not unusual to find one vehicle used by the principal or shareholder and others by family members, unconnected with the business. Porsches, Corvettes, and other luxury autos are unlikely to be used to pick up the occasional parts and supplies that are not delivered by the vendor.

The most common issues encountered are outlined below under the broad categories of vehicle ownership, though it should be noted that ownership, as stated on a depreciation schedule, should not be regarded as gospel.

Some of the following sections deal with corporate vehicles. In a sole proprietorship, the vehicles used are treated in the same way a corporation treats nonbusiness use by a 5-percent shareholder or related person.

Vehicle Owned by Corporation

Compensation of an unrelated, non-shareholder employee should be increased by an amount equal to the fair market value of his or her personal use portion of a company vehicle as described in IRC section 280F. If this is the case, or if a like amount is reimbursed the employer, operating expenses are wholly deductible and depreciation is allowable at 100 percent of the maximum amount scheduled for the date acquired. If the value is not included in the employee's gross income however, the personal portion of its use is not considered to be qualified business use.

When a company vehicle is used by a 5-percent owner or a related person, as described in IRC section 267(b) the above exception does not apply and the personal use portion is never considered to be qualified business use. It is not uncommon to increase shareholder compensation or adjust his or her loan account based on personal auto use and also to deduct the full allowance for depreciation available for the period. More often, however, no additional compensation is computed and a constructive dividend can be assessed, equal to the fair market value of personal vehicle use, as well as an adjustment made to the expense accounts.

The safe haven policy prohibiting personal use except commuting, is not available if the commuting employee is an officer, director, or 1-percent owner.

Vehicle Owned by Shareholder

Monthly principal and interest payments for one or more vehicles owned by the shareholder (or sole proprietor) were often made by the company and deducted as auto expense. In one instance such checks, to BMW (Credit) were also listed in the purchase account. In the case of a corporation, the payments made on the shareholder's behalf constitute a constructive dividend, with the interest element subject to consumer interest deduction restrictions on the Form 1040.

Other auto expenses paid by the corporation, such as the cost of fuel, maintenance, accessories, insurance, and registration, are also made for the benefit of the shareholder and are subject to partial or full disallowance depending on the extent of reimbursable

business use. It is not unusual to find that insurance paid covers all of the shareholder's family cars or that the company credit card is routinely used to supply fuel for a number of non-business vehicles.

Leased Vehicles

Personal use of leased vehicles is taxable to the user based on the percentage of business use multiplied by the fair lease value of the vehicle. If the lessee is a corporation and has not made this addition to a shareholder's compensation or been separately reimbursed by the shareholder, the excluded amount constitutes a non-deductible dividend paid to him or her.

Businesses leasing luxury autos are required to increase gross income by an "inclusion amount" computed as shown in Treas. Reg. section 1.280F-5T. That amount is often overlooked or miscalculated.

ENTERTAINMENT AND PROMOTION

Some entertainment expenses are to be expected in the auto body and repair industry. Parts managers at dealerships who may recommend the shop are often entertained and there might be an occasional lunch with an adjuster to discuss differences, but these events would not usually be frequent or lavish. Christmas gifts are frequently given to those who have referred business to the shop during the year.

Most of the businesses examined did not report substantial amounts of entertainment and promotion expense. Shops grossing between \$1 million and \$2 million per year typically claimed less than \$10,000 in combined expenses. Some of the businesses examined in the course of this study, however, reported much higher costs, ranging up to a startling \$134,000 in one case. As might be anticipated, this group produced most of the adjustments made.

The issues most commonly encountered are outlined below and are similar to those found in other small businesses.

Inadequate Verification

Inadequacies ranged from no verification at all to a lack of one more of the elements required under IRC section 274. In the case of some closely held corporations, it was suspected that withheld documents contained evidence of substantial personal expense that

would have resulted in a dividend to the shareholder as well as disallowance of the corporate deduction had they been produced.

Personal Expenses

Personal living expenses of the owner or shareholder were nearly always present on company credit card charge statements. In some cases, these were identified by the taxpayer and charged to the drawing or loan accounts. In most cases, they were added to the business expense accounts.

Misclassified Business Meals

Business meals and entertainment were not uniformly charged to the entertainment account, but could be found in selling expense, promotion, travel, and even office expense. Misclassified entertainment was not reduced by the obligatory 20 percent (50 percent for taxable under IRC section 274(n)).

Gifts

Merchandise or cash gifts were often given to individuals such as parts department managers and employees who had referred business to the company. The expense was found in a variety of accounts including promotion, advertising, and outside services and generally exceeded statutory limits, often by substantial amounts. Gift recipients should be identified and no presumption made that a case of Dom Perignon or Cristal was presented to 12 different business associates.

Expense Allowances

One corporation issued biweekly checks to a shareholder-officer, charging the amount to entertainment expense. No account of the expenditures was submitted to the employer and the shareholder also held a corporate credit card which was generously used for such purposes. Such an arrangement should produce at least additional compensation to an employee and probably a dividend to the shareholder in the absence or written company policy.

RENT EXPENSE

Expenses claimed for rent in auto body and repair shops usually include leases of both real and personal property.

Real property rents generally cover only the business site and parking facility if required, but at least one company in the study also included the rental of a vacation condominium.

Personal property leased by the business can include shop machinery and equipment and vehicle leases. Auto leases are often stated separately and issues arising from the examination of vehicle leases are discussed at Auto Expense.

Real Property

The cost of business site rental for body and repair shops varies widely and can often appear to be quite exorbitant at first glance. Property of adequate size, with the requisite parking available, in an attractive location, that is also zoned properly, is difficult to find, even in a down market. A high profile location can, therefore, command a premium price.

When property is leased from a related party, however, the cost of the lease should be scrutinized to determine if the rents are reasonable. A shareholder with passive losses, for example, may prefer to forego a dividend or decrease his or her salary and increase his or her rental income. Excessive rents paid to a shareholder are considered equivalent to a distribution with respect to stock.

Occasionally, an acquisition fee is paid to obtain a lease or to sublease property on favorable terms. If this is the case, the fee must be amortized over the term of the lease.

Security and other deposits are required to obtain almost any lease and must be capitalized. No amortization is allowable and they cannot be written off unless they have been used at lease termination or otherwise released for use by the lessor.

Payments covering a period extending beyond the taxable year are not deductible regardless of the taxpayer's accounting method.

Examination of the lease itself can reveal the lessor and the terms, that is, the size of the property and its location, the length of the lease, the deposits required, any COLA escalation terms and the responsibility of the tenant for related expenses such as tax and utilities. This information will assist in the audit of the previously mentioned items and related expense.

The size and location of the property as described by the lease may have appeared obvious during the tour of the premises but the description appearing on the lease paid by one of the businesses examined revealed that it covered the site of an adjacent, unrelated business, as well as that of the lessee's business. In that case, no rental income was reported, nor were there any credits to the expense account.

In two of the cases examined, a resort property owned by the shareholders was leased by the corporation. In this situation, it was necessary to determine: a) if fair rental value was charged and, b) if the rent was deductible in any part, under the entertainment facility provisions of IRC section 274.

As with many other disbursements, a Form 1099 is often required for lease payments.

Personal Property

Leases of the machinery and equipment used in body and repair shops, are frequently capital in nature. Payments consist of the amount of principal and interest necessary to amortize the cost over the 2 to 7-year term of the lease with a very nominal residual payment, often \$1 to \$10. The lease contract will clearly state the terms, but the equipment is seldom capitalized when required. This omission may be to the taxpayer's detriment in the early years of a long-term lease.

INSURANCE

Insurance can be a relatively large expense category for auto body and repair shops, due to the high business liability and workers' compensation rate classifications assigned them. The deduction taken may include premiums for a business umbrella policy, workers' compensation, health insurance, vehicle coverage, and life insurance. Group health plan costs are often deducted separately as employee benefits and automobile insurance may be included in car and truck expense. In the course of this study, adjustments were found in most of the areas mentioned below.

Prepaid and Accrual

If the company maintains an asset account for prepaids, it is often cleared at year-end, even though coverage extends considerably beyond the end of the year under examination. Accrued costs may similarly include

premium expense attributable to subsequent periods. A review of the last expensed invoices for each policy should reveal both the coverage and the term. Any prepayments are not deductible until the applicable period.

Dividends, Refunds and Claims

Workers' compensation policies often pay large dividends to subscribers based on the prior year's experience. The premium refunds are usually treated as a reduction to the expense accounts, but may be recognized as other income. When dividends are received in one year, but not the next, or when the accounting treatment varies, a comparison of expense claimed can show considerable variance between periods. One should determine whether dividends were paid and if they were properly accounted.

Cancellation or alteration of any insurance policy in mid-term can also result in a refund of a portion of past premiums paid.

Claims filed under policies for losses of assets may result in taxable income which is often improperly treated. The original tax treatment of the items constituting the loss and the accounting treatment of any replacement should be determined to rule out the possibility of a double deduction of the loss. This will effectively occur when the insurance revenue is not reported as income and the cost of the lost items has been expensed.

Medical Insurance

Some of the shops examined carried group health insurance plans, but company policies regarding the plans varied. When the employees are required to pay a portion of the cost, usually by payroll deduction, the expense account will be credited for the withheld amounts. At year-end, a similar credit should be accrued, representing the insurance portion of the payroll expense accrual.

More often, medical insurance paid for and deducted by the company covered only the shareholder or owner and his or her family. Such discriminatory payments are not deductible business insurance expense and, in the case of a corporation, equate to constructive dividends to the shareholder. The personal medical insurance expense is, of course, deductible on a limited basis on Schedule A of the Form 1040, or in part, as an adjustment to income, in the case of a sole proprietorship.

In either of the situations listed above, individuals other than employees may be covered by the plan, perhaps in order to secure better or cheaper coverage than would otherwise be available. They may reimburse the company for coverage and this would probably be booked as a credit to the expense account. If there is no reimbursement, the deduction is unallowable and a dividend is deemed to be paid to a shareholder if he or she receives funds or is related to the recipient.

Life Insurance

None of the auto body and repair shops examined on the course of this study carried deductible group term life insurance policies as described in IRC section 79.

Many of the companies did deduct payments for life insurance coverage for shareholders and officers. If the company is directly or indirectly the beneficiary of any such policy, no deduction is allowable under any circumstances, and the amount paid should be shown as a corporate Schedule M-1 adjustment. If the corporate shareholder is the owner and beneficiary of the policy, his or her compensation should be increased to reflect the benefit, or his or her loan account debited. If this is not the case, the premium paid constitutes a nondeductible dividend paid to the stockholder. In the case of an employee, unrelated to a shareholder, the premiums paid constitute additional compensation to the employee. In a sole proprietorship, no deduction is allowable.

Split-dollar life policies should be reviewed to determine if suggested assignments and endorsements have been made as to ownership and beneficiary, and if the employee has been taxed on, or paid the company the value of the economic death benefit. The company cannot deduct its share of the premium. In one case, the value of the death benefit was miscomputed by the insurance company. Resulting in an understatement of the benefit by six-fold. The amount of the benefit can easily be approximated using a table of PS-58 costs.

Auto Insurance

Reference should be made to the general categories above for vehicles used wholly for business purposes. When personal use allocations are required, consult the section covering auto expenses.

OFFICER COMPENSATION

It is not unusual to find officer-shareholders in successful auto body and repair shops earning salaries in the lower end of six figures. Those in the same position in fledgling and failing businesses, however, will often draw limited salaries until such time as the company's situation improves. Such variations in the amount of compensation paid for the same job done by the same individual for a closely held business, can serve sound business purposes and make it difficult to determine what level of compensation is reasonable for a specific executive position.

Reasonable Compensation

Section 162(a)(1) of the Internal Revenue Code states that compensation paid to employees is a deductible business expense to the extent that it is reasonable. Treasury Regulation section 1.162-7(b)(3) attempts to clarify the term "reasonable" by stating that it "is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances." Generally, compensation in excess of the amount determined reasonable, is treated as a dividend when paid to a stockholder.

Having stated that officer's salaries in closely-held businesses can cover a broad range, there are, nevertheless, instances where it becomes evident that some or all salary payments made to a particular individual are excessive.

It is not necessary that a salary be particularly high to be excessive. An accountant tells a story about the stay-at-home wife of a corporate president client who was paid a fairly modest salary by the company. At the accountant's instruction, she was at the business site on the morning that an audit of the corporation began and the examiner was assured that her services to the firm were invaluable. The deception went well until the woman asked the receptionist for the location of the restroom.

The situation described in the preceding anecdote is not very unusual. Spouses, parents, children, or even a sole shareholder may not actually perform services for the corporation paying their salary. They may not all so conveniently reveal the pretense, but careful questioning of the employer, inspection of the minutes, and attention to detail can often serve the same end. To confirm suspicions aroused, inquiry can also be made of former or current employees.

Also encountered in the course of this study was the situation described in Treas. Reg section 1.162-7, where excess salaries drawn by officers bear a close relationship to their stock holdings and represents a distribution of corporate earnings. Further described is a situation where excess compensation can represent payment for property.

In cases where there has been an ownership change, salary levels for officers before and after the change, can be compared. A decrease can be indicative of excess compensation paid prior to the change while an increase may indicate a payment made for property or goodwill not otherwise deductible by the acquirer.

Bonuses

Bonuses are often paid to officers at fiscal year-end depending on the profitability of the business. Though they sometimes bear an uncanny relationship to the relative amounts of corporate stock held, they are deductible as compensation to the extent that total compensation paid, including the bonus, is not excessive.

The year-end corporate minutes often describe the amount of bonuses to be paid, the reasons for payment, and may set salaries for the subsequent year.

All bonus payments are taxable as wages and subject to withholding as discussed in the employment tax section of this guide.

Journal Entries

In addition to, and sometimes in lieu of, regular salary payments, officers in a closely held business occasionally draw additional funds in the form of loans.

It is not unusual to journal all or part these advances over to salary expense or a bonus account at the end of the year. When such an entry is made, the amount is includible in the officer's income on the entry date, since he or she received the funds at that time.

Journal entries are usually made sometimes after the closure of the fiscal year but dated at the fiscal yearend. In this case, the Form W-2 can be incorrect if fiscal and calendar year coincide and should be reconciled.

Accruals

Bonuses and annual salaries are often accrued at the end of the corporate fiscal year but paid at a later date. Under IRC section 267(a)(2) the deduction is allowable only when the income is includible in the gross income of the recipient if the payee is a related party as described in IRC section 267(b). A corporate employee who actually or constructively owns more than 50 percent of its outstanding stock is considered a related party.

Section 404(a)(5) of the Code may be applied to deferred compensation when an employee owns 50 percent or less of the corporate stock.

Section 461 of the Code requires economic performance before certain liabilities are considered incurred. For liabilities arising from the provision of services, economic performance is generally the performance of the services. Payment of liabilities arising from services to be provided to the taxpayer does not obviate the necessity of the performance of those services for the accrual of the liabilities, except if such expenses are of a recurring nature. Where the expense is recurring, payment must be made within 8 ½ months after the close of the year to be deductible in the year accrued for financial statement purposes.

LOAN ACCOUNTS AND RELATED INTEREST EXPENSE

Loans or advances made to related parties are common to many closely held businesses. Corporate loans to shareholders are probably the most commonly seen, with advances from the shareholder to the corporation running a close second. The latter situation is routinely seen in the early years of closely held but thinly capitalized corporations.

Stated interest payable on such loans by an accrual basis corporation may not be deductible for tax purposes until includible in the income of a related payee as described in IRC section 267(b). If those criteria are not met, the deduction of the accrued expense may be denied under the provisions of IRC section 461(h). In either situation, accrual of the expense for financial statement purposes is proper and an adjustment should appear on Schedule M-1 of the corporate return.

Less formal loans, without stated duration or interest, are at least as common as those described above. These are treated as demand loans, and if not de minimis, are

subject to the provisions of Section 7872 of the Internal Revenue Code, discussed at length below under the heading "Imputed Interest."

It is often worthwhile tracing balance sheet changes in the loan accounts to their source. Decreases in officer liability caused by noncash contributions, such as a vehicle for restoration, can indicate income to the donee if the fair market value credited exceeds basis. Decreases caused by large cash paybacks might prompt inquiry as to the source of the funds. Increases due to corporate payment of personal expense can reveal the nonbusiness nature of similar expenses deducted in other accounts. If noncash distributions cause an increase in the loan account, the fair market value of the item or items transferred, if greater than booked value on transfer, can produce a dividend. No loss is allowable in the case of related party transfers.

One situation encountered in the course of this study, while perhaps unusual, bears mention. An auto body shop doing business as a corporation was owned by two relatives, each a 50-percent shareholder. They operated the business at two sites and kept separate records for each location, which were combined at year-end. The two had a falling out and split up the business, with one retaining the old name and one former site and the other incorporating a new business at the second site. In the course of dividing the assets, the loan account of the new corporation's stockholder simply vanished from both restated balance sheets. Neither the transaction or the forgiveness was reported.

Imputed Interest

Although imputed interest on below market rate loans is not actually an expense issue, it is included in this section due to the frequency with which the issue arose on corporate examinations and the recurring need to trace back advances through the cash disbursement records.

Interest free demand loans made by a corporation to its shareholders were most frequently encountered during this study, but related party loans and loans from shareholders to the corporation were also discovered.

Under Section 7872 of the Internal Revenue Code the foregone interest on such below market loans is treated as transferred from the lender to the borrower as of the last day of the calendar year and retransferred immediately from the borrower to the lender as interest. There is a \$10,000 de minimis exception for

compensation-related and corporate-shareholder loans that do not have tax avoidance as one of the principal purposes.

When a corporation makes interest free (or low interest) loans to its shareholders, the following actions are deemed to have occurred:

1. The shareholder receives a nondeductible dividend in the amount of the foregone interest.
2. The corporation receives a like amount of interest income.
3. The shareholder is able to fully deduct the interest deemed paid to the corporation prior to 1987, when the phase-out of the consumer interest deduction began. After 1990 no deduction is allowable unless the expense can be demonstrated to be investment related.

If the corporate loan is made to an employee, who is unrelated to a shareholder, the scenario is similar except in this case:

1. The forgone interest is characterized as additional compensation to the employee.
2. The corporation received deemed interest income in a like amount.
3. The corporation can deduct the amount as compensation expense but may be liable for employment taxes on the additional wages.
4. The employee may be able to take a deduction for interest expense depending on the year and use of the funds.

When a below interest rate loan is made between otherwise related entities, or a shareholder makes a loan to his or her corporation, the adjustments resulting after imputing the interest are:

1. The lender receives interest income in the amount of the foregone interest.
2. The borrower has deemed interest expense in a like amount.

Although the transfer of taxable income between entities may appear to be offsetting, there can be significant tax impact in the reallocation, depending

on the relative tax brackets of the borrower and lender and the deductibility of the expense deemed paid.

The Treasury Regulations contain detailed instructions for computing the interest imputed on interest free and below market rate loans using published Federal rates and should be consulted for guidance. A simplified method is available for use in imputing interest on loans of \$250,000 or less. If loans exceed that amount, a business or financial calculator capable of raising "x" to the "y" power, will be required.

Despite the fact that the computation may seem somewhat tedious at first, adjustments can be substantial and are easily sustained. On a related return pickup made during the study, shareholder loans to his corporation averaged \$700,000 over the 1989 and 1990 and increased to \$1,400,000 by the end of 1991. Interest of about \$60,000 could be imputed for 1989 alone. The corporation had paid only \$3,000 in recoverable tax between 1986 and 1991, thus highlighting the impact of differing tax brackets.

EMPLOYEE RELATED EXPENSES

Although the accounts discussed below have not proved particularly productive in themselves, the examination of these employee related accounts can help to make or sustain a status determination if employment tax issues exist.

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.

Employee Advances

Some employers regularly make advances to employees and often allow them to repay larger amounts in installments through payroll withholding. A contractor might also be advanced funds occasionally, but the advance would probably be posted to the expense account and fully offset the final payment due for the completed job.

Group Plans

All individuals covered under an employee group plan should be employees of the company or dependents and premiums withheld, if present, should be consistent. If an individual treated as an independent contractor is covered under such a plan, his or her status would be questionable.

Bonuses and Gifts

Bonuses are not customarily paid to nonemployees. If an individual treated as an independent contractor receives a bonus or gift certificate at Christmas, as do the employees of the company, an additional factor would be provided to question his or her status.

Expenses Reimbursements

The company's reimbursement of an individual's automobile mileage and routine job related expenses tend to indicate that the person is an employee.

UNETHICAL PRACTICES

There were some practices encountered in the industry that range from unethical to criminal. Only one was commonly seen, however, and only one company examined was guilty of most of them. Towing companies themselves were not examined, nor was any business issuing smog certificates. The information included below regarding these businesses, (except as it relates to body shops), was supplied us or confirmed by the enforcement division of the Bureau of Auto Repair. It is included here for information purposes only.

Automobile Rental Kickbacks

A kickback on auto rentals was the one practice commonly seen at body shops and, to a lesser degree, repair shops. 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

So called "bird dog" fees are paid to individuals by body shops for referring customers to the shop. In California, this is illegal under the Insurance Code if the individual receiving the payment is an independent adjuster, insurance agent, or broker. It does not appear to be illegal for others to accept such consideration, but insurance company and dealership employees would certainly not want their employer made aware that they accepted such favors.

One body shop examined commonly paid finders fees ranging from \$50 to \$500 per vehicle to a cadre of individuals that included at least one insurance agent and an insurance adjuster for a major company. Although the considerable cost could not be disallowed as an illegal expense, the fees tended to mount up over the course of a year and no Forms 1099 had been filed. Both the Form 1099 penalties and backup withholding are appropriate in such a case.

The same body shop also paid three dealerships very large monthly fees, presumably to refer business. Although request for confirmation of the purpose of the payments went unanswered, this presumption was reinforced by unsolicited third party testimony regarding industry business practices and the particular shop. Most dealerships that lack their own body repair facilities refer their customers to three different body shops on a rotating basis and base that recommendation on the quality of work done. It is unusual to see a regular payment made to secure referrals, although moderate Christmas gifts to dealership personnel are not unusual.

Political Contributions and Lobbying Costs

Political contributions and most lobbying expenses are not deductible. One body shop, located adjacent to a residential area, deducted contributions to the local councilman and a political action committee, and the costs of lobbying to secure a zone variance. They had unconditionally leased and begun doing business on the site with the acknowledgment that the property was improperly zoned for a body shop. When their neighbors complained, the variance was sought and secured at considerable expense.

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 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. The maximum recovery for costs is fixed by Section 22851.12 of the California Vehicle Code at \$75 and \$100.

A moderately sized body shop, grossing about \$2 million a year could be expected to have no more than a very few such filings a year, and many will have none. One of the larger shops examined, however, filed for lien sale of nearly 100 cars a year. The company was operating a scheme in conjunction with a towing service, as outlined below. Other signs of the arrangement were large monthly towing charges paid to the particular service and many reported sales, particularly sales of older vehicles.

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. In one case cited above, the payment was 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.

The usual scheme then proceeds as follows: The towing service delivers a succession of vehicles involved in crashes to the body shop, some wrecked beyond repair. Once the cars are on the premises, the shop begins charging for storage, sometimes at inflated rates, and may also charge a fee for an estimate. If an insurance company is involved, the total of these charges and the towing costs, plus the cost to tow a totaled vehicle to its salvage yard quickly becomes more than it can realize from its sale. An uninsured individual may not have the means or find it worthwhile to redeem his or her still wrecked vehicle. The vehicle is then sold at a lightly publicized lien sale at a price which is usually less than the accumulated charges to a nominee not unacquainted with the body shop. It can then often be repaired and sold economically, since the accumulated fees and charges are not a consideration. Although this practice does not appear to be illegal, vehicle sales should be illegal, vehicle sales should be reported as well as income from the storage charges demanded by the shops involved.

Towing companies have been embroiled in some well publicized scandals involving variations of this scheme. Although they are not in a position to repair the vehicles themselves, sales at a nominal price can be made to related parties at the poorly attended sales. The towing charges and storage fees are all that is recovered even though the car may be more valuable. Had the selling price exceeded the accumulated charges, the excess recovery would be payable to the State of California.

The towing services have been quoted as stating that, because the sales were poorly attended, prices fetched for vehicles was low. Since the publicity given the scheme and indirectly, the sales in the media, attendance has increased as have the selling prices.

Insurance Fraud

Insurance and consumer fraud have both received a great deal of media attention in recent months. One of the body shops examined reported an extremely high profit margin on parts, but inspection of the purchase invoices from its suppliers indicated that the shop received only the usual 20 to 25 percent discount. It was later confirmed through a law enforcement agency that they were 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

In another, widely publicized case, involving the auto repair services of a national chain, parts were found to have been sold to consumers that were not required and even said by some reports not used on the vehicles. Obviously, such a practice has the effect of greatly increasing the true profit margin.

Some towing services and body shops have been shown to be involved in referrals of customers to unscrupulous attorneys and doctors engaged in insurance fraud. A fee is collected for each referral made. No company examined reported the receipt of income from such practices, however, and we discovered no unreported income from this source in the course of this study.

Smog Certificate Sales

Although none of the examinations conducted involved a business engaged in the emissions testing of vehicles

or the sale of smog certificate, the Bureau of Automotive Repair has reported that a great deal of abuse exists in this sector.

A particularly lucrative scheme currently in operation 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. It thus poses a tempting solution to many who apparently provide these operators with ample business. The scheme is highly profitable for the dealer, but it is said that most of the profits are not reported or at best, are vastly understated.

Should such a dealer be encountered, it is suggested that the Department of Consumer Affairs be contacted for information regarding the number of certificates issued to the facility. Customer contact may then be possible to determine the average fee collected and thus approximate income.

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Chapter 8

CHANGE IN ACCOUNTING METHODS

INTRODUCTION

Because inventory adjustments have been consistently made in the auto body/repair industry, the examiner will find it necessary to become acquainted with procedures for making a change in accounting method. For a taxpayer on the accrual basis, the change will be limited to the inventory itself. For a cash basis taxpayer, the change in accounting method will include the sales and purchases, as well. With the advent of Revenue Procedure 92-20, the examiner must also consider the possibility of allowing the taxpayer to spread the adjustment over several years.

WHY MAKE AN IRC SECTION 481 ADJUSTMENT

IRC section 481 was established to prevent amounts from being duplicated or omitted when a change in accounting method was made. In normal situations where the taxpayer makes a change voluntarily by filing a Form 3115, he is allowed to spread any increase in taxable income over a number of years to avoid a distortion of income. In an audit situation, the taxpayer's options may be limited or curtailed altogether depending upon the type of adjustment made. In both cases, the IRC section 481 adjustment must be segregated from what is termed the "current year" adjustment to allow for potentially different treatment.

INVENTORY ADJUSTMENT

When a determination has been made that inventory must be established as part of cost of sales to more clearly reflect income, consistency dictates that the computation include both the beginning and ending inventory amounts. This consistency requirement gives rise to two separate tax adjustments. One is termed the "current year adjustment." The other is considered the IRC section 481(a) adjustment. The differentiation must be made because each may be taxed differently depending upon the available options allowed by the Code, regulations, and Revenue Procedures.

The computation of the actual inventory amounts is discussed in the "Cost of Sales" section. As mentioned before, an examiner would utilize the various repair

orders and invoices to compute the inventory amounts. There would be a difference in the computational method in regards to either the beginning or ending inventory.

After the computation of the beginning and ending inventories for a particular year, the current year adjustment is determined by simply taking the difference between the original and revised cost of sales amounts. This adjustment can be either negative or positive depending upon which increase (beginning or ending inventory) is larger.

The IRC section 481(a) adjustment is the increase or decrease in the beginning inventory for the year of change. The following presents an example.

Example 1

An adjustment is proposed to an accrual basis auto body shop which had never previously maintained inventories. The year of audit is the calendar year 1990 and the entity is a corporation. The beginning inventory has been computed at \$30,000 and the ending inventory has been computed at \$40,000.

| | Per Return | Revised | Difference | Treatment |
|------------------------------|------------|-----------|------------|------------|
| Begin. Inventory @ 1/1/90: | 0 | 30,000 | 30,000 | IRC 481(a) |
| Purchase | 600,000 | 600,000 | 0 | |
| Labor | 600,000 | 600,000 | 0 | |
| Ending Inventory @ 12/31/90: | 0 | (40,000) | (40,000) | |
| | ----- | ----- | ----- | |
| | 1,200,000 | 1,190,000 | (10,000) | Current |
| | ===== | ===== | ===== | Yr. Adj. |

Since the cost of sales has been decreased, a positive tax adjustment of \$10,000 is proposed for the 1990 year. Because the taxpayer has been given credit for the \$30,000 beginning year adjustment, to prevent an omission of income, the \$30,000 will be considered the IRC section 481(a) adjustment.

It should be noted that for the Service to be consistent in its position, the subsequent years should be audited (with group manager's approval) and adjustments proposed for the same issue. The subsequent year's adjustments will be considered current year adjustments and will be taxed in the respective years.

COMPUTATION OF ACCRUED SALES AND PURCHASES

If an adjustment to establish inventory for a cash basis taxpayer is proposed, another factor to consider is Treas. Reg. section 1.446-1(c)(2). This regulation stipulates that the accrual method of accounting must be used with respect to purchases and sales when it is necessary to use an inventory. In this case, the examiner will also need to compute the accrued purchases and receivables. As with the inventory adjustment, to prevent duplication or omission of adjustments, an IRC section 481(a) adjustment will arise which is the net effect on taxable income of the increase in the beginning accounts receivables and accounts payables amounts.

Computation of IRC Section 481 Adjustment for Accrued Receivables

This step involves the reclassification of cash sales in the beginning of the year to prior year accounts receivables. As with the inventory adjustment, the ease of the computation will depend upon the records available and how they are organized. To start the computation, request the sales journal, repair orders and/or estimates.

The concern with establishing accounts receivables is determining when the taxpayer has earned the income under the accrual method. Per. Treas. Reg. section 1.451-1(a), "...income is includible in gross income when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." In the auto body business, this point is usually when the job has been completed. However, there may be a significant time lag between completion of a job and the recording of a sale for a cash basis taxpayer. The examiner may need to sift through repair orders and other records to determine the starting and completion points.

Situation 1. The taxpayer records income as payments are received (deductible and insurance checks are recorded separately)

In some situations, the deductible payments are not received at the same time as the insurance check. The customer may pay the deductible when the vehicle is picked up and the insurance company may pay the remainder of the bill at a date possibly 5 or 6 weeks later. Income is recorded separately for the same customer; once when the deductible is received and once when the insurance check is received.

A starting point in the computation of the IRC section 481(a) adjustment would be the sales recorded at the beginning of the taxable year. Since insurance checks are usually paid within 6-weeks, the sales for the 6-week period at the beginning of the year of audit should be researched. If the audit is for the calendar year ending December 31, 1990, the IRC section 481(a) computation of beginning receivables would require examination of the sales recorded for January 1 through February 14, 1990. If a sales or cash receipts journal is available, this may be the appropriate starting point. Since most auto body shops only record the date the income is received in their sales journals, the repair orders and/or estimates will also need to be requested to establish a starting date.

Once the repair orders and/or estimates have been received, the next step will be to check the date the job was actually started. A receivable may only be established if the job was started **and** completed before the end of the prior year. If the repair order states that a job was started after the beginning of the year then the receivables and inventory consideration may be passed.

In this situation, the key event to determine is the actual completion of the job. This date is usually pretty close to the date the customer picks up the vehicle or it may even be the same day. In many situations, the body shop will require payment of the deductible before the vehicle is released. Therefore, the date the deductible payment is recorded offers a good starting point to consider the job completed. If the taxpayer maintains a sales journal by customer name then insurance checks can be associated with the deductible payments. The receivable would then be the total sale less the deductible payment.

Determination of Accrued Purchase

The examiner should obtain the disbursement journal for the year and concentrate on the first month. Invoices can then be requested for purchases and analyzed to determine if received in a prior year and paid in the current year. If the examiner has already performed inventory test work then many of the same files may be available. The same procedures may be applied to the end of the year transactions.

IRC SECTION 481(B)(1) & (2) LIMITATIONS

Once the IRC section 481(a) adjustment has been computed, the first consideration the examiner needs to make is whether the adjustment can be taken all in one year. Notices and Revenue Procedures have been published which mandate certain IRC section 481(a) adjustments be taken entirely in the year of change. If no rulings dictate that the adjustment be taken all in one year, consider whether IRC section 481(b) is applicable.

IRC section 481(b) provides a limitation in the amount of tax an IRC section 481(a) adjustment can generate. It is designed to alleviate situations where taxable income has risen over several years. Taxation of the IRC section 481(a) adjustment in a current high tax bracket would be unfair if part of the adjustment was attributable to prior year's when income was lower. This limitation is created by allocating the adjustment over prior years and computing the resulting increase in tax. It should be noted that the prior year's returns are not opened and the limitation per IRC section 481(b) is different than the methods provided for in Revenue procedure 92-20.

Before IRC section 481(b) is applicable, several criteria must be met. The first is that the IRC section 481(a) adjustment must increase taxable income for the year of change by more than \$3,000. The second criterion is that the method previously used by the taxpayer is consistent with that employed in the year of change.

If the above criteria have been met then the following steps should be taken in computing the limitation in tax:

1. Compute the tax solely associated with the IRC section 481 adjustment:

The first step is to compute the increase in tax for the year of change which is attributable solely to the adjustments required under IRC section 481(a) and Treas. Reg. section 1.481-1. This is the excess of the tax computed including the IRC section 481(a) adjustment over the tax computed without taking the IRC section 481(a) adjustment into account. It should be noted that if there are other non-IRC section 481 adjustments which are also being made, these must be taken into consideration when computing the tax before the IRC section 481(a) adjustments.

2. Compute the tax under IRC 481(b)(1) - 3 year allocation:

In this step, the IRC section 481(a) adjustment is equally allocated to the year of change and the 2 preceding taxable years. The increase in tax attributable to the adjustments for each such taxable year is the excess of the tax for such year computed with the allocation of one-third of the IRC section 481(a) adjustment over the tax computed before consideration of the IRC section 481(a) adjustment.

3. IRC section 481(b)(2) - Allocation under new method of accounting.

If the taxpayer can establish from his or her books and records what his or her taxable income would have been under the new method of accounting for one or more consecutive taxable years immediately preceding the taxable year of change and the old method has been consistently applied for those consecutive years, then the IRC section 481(b)(2) limitation must also be considered. The increase in tax attributable solely to the IRC section 481(a) adjustment is the increased tax resulting from the allocation of the appropriate portion of the IRC section 481(a) adjustments to the one or more consecutive preceding taxable years over the tax previously computed.

If the taxpayer meets the above criteria the limitation on the tax is the smallest of the three computations stated above.

Example 2

Using the information in Example 1, an inventory issue results in a decrease in cost of sales for the current year of \$10,000 and an IRC section 481(a) adjustment of \$30,000. The examiner is also proposing T & E adjustments of \$50,000 and an omitted interest income adjustment of \$30,000 for the calendar year 1990 year.

Step 1 - Compute tax solely associated with IRC section 481(a) adjustment for calendar year 1990.

| | | Tax |
|--|------------------------|----------|
| Taxable Income per Return: | \$60,000 | \$10,000 |
| Non-481(a) Adjustments | | |
| - T & E | 5,000 | |
| - Interest Income | 3,000 | |
| - Cost of Sales (Current year Adj) | 10,000 | |
| Taxable Income Before 481(a) Adj. | 78,000 | 14,770 |
| IRC 481(a) Adjustment | 30,000 | |
| Taxable Income with 481(a) Adj. | 108,000 | 25,370 |
| Increase in tax due solely to 481 adj: | (25,370-14,770) 10,600 | |

Note that the tax is computed with current year adjustment included.

Step 2 - Compute tax solely associated with IRC section 481(a) using 3 year allocation method.

| | 1988 | 1989 | 1990 |
|---|----------|----------|----------|
| Tax Income per return or as adjusted | \$30,000 | \$55,000 | \$78,000 |
| Tax: | 4,500 | 8,750 | 14,770 |
| 481(a) Allocation: (30,000/3) | 10,000 | 10,000 | 10,000 |
| Recomputed Tax Income: | 40,000 | 65,000 | 88,000 |
| Tax on Recomputed Inc | 6,000 | 11,250 | 18,170 |
| Increase in Tax | 1,500 | 2,500 | 3,400 |
| Total Increase : | \$7,400 | | |

Step 3: The taxpayer states that he can recompute his taxable income under the new method for the years 1987, 1988, and 1989 and does so. The beginning and ending inventories are restated as follows.

| | 1987 | 1988 | 1989 | 1990 |
|---------------------------------|----------|----------|----------|---------|
| Begin Inventory | \$20,000 | \$35,000 | \$35,000 | |
| End Inventory | 35,000 | 35,000 | 30,000 | |
| Net Effect on Taxable Income | 15,000 | 0 | (5,000) | 20,000* |
| TI per Return or Adjusted | 25,000 | 30,000 | 55,000 | 78,000 |
| Revised TI | 40,000 | 30,000 | 50,000 | 98,000 |
| Tax before Section 481(a) | 3,750 | 4,500 | 8,750 | 14,770 |
| Revised Tax | 6,223 | 4,500 | 7,500 | 21,570 |
| Net Tax Effect | 2,473 | 0 | (1,250) | 6,800 |

Total Tax Increase \$8,023

* Per Regulations, using IRC section 481(b)(2) method, any IRC section 481 adjustment not accounted for by the prior year's recomputations, is retained in the year of change. In this case, the 481 adjustment of \$30,000 is decreased by the 1987 and 1989 net change of \$10,000. The remainder is retained in 1990.

Step 4: The change in accounting method will, therefore, result in the smallest of the three increases above. The tax increase resulting from the IRC section 481 adjustment will, therefore, be limited to \$7,400.

REVENUE PROCEDURE 92-20

Revenue Procedure 92-20, 1992-1 C.B. 685, provides the administrative procedure applicable to change in methods of accounting. Rev. Proc. 92-20 applies the "carrot and stick" approach by using a gradation of incentives to encourage prompt voluntary compliance with proper tax accounting principles, and to

discourage taxpayers from delaying the filing of applications for permission to change an impermissible method of accounting. Rev. Proc. 92-20 modified and superseded Rev. Proc. 84-74 with respect to Forms 3115 filed on or after March 23, 1992.

Under Rev. Proc. 92-20 taxpayers are provided with more opportunities than under Rev. Proc. 84-74 to request changes in accounting methods while under examination.

An entire dissertation can be written regarding how a change in accounting method should be handled. Because this guide deals with a specific type of accounting methods adjustment, the focus of the procedures will be narrowed to deal with these. If the examiner encounters other changes in accounting method with auto body shops, he or she should research the respective Revenue Procedures for the treatment.

As such the following is assumed:

1. The taxpayer is under examination
2. The proposed change in accounting method is either an inventory requirement or a change from the cash receipts and disbursements method to the accrual methods of accounting. (These are Category A methods of accounting. A Category A method is any method that is specifically not permitted to be used by the taxpayer by the Internal Revenue Code, Income Tax Regulations, or by a decision of the U.S. Supreme Court. A Category A method is also any method that differs from a method the taxpayer is specifically required to use the Code.)
3. The IRC action 481(a) adjustment is significant enough to warrant consideration of the spread period.

Generally, a taxpayer that is under examination may not file an application to change an accounting method without obtaining the consent of the District Director. Therefore, unless the taxpayer meets one of the window exceptions stated below, the adjustment may be made in the earliest open year with no forward spread of the IRC section 481(a) adjustment.

The following options would be available to the taxpayer under an examination situation for a Category A type adjustment:

90 Day Window

This window allows the taxpayer(s) 90 days, starting after the beginning of the examination, to file a form 3115 with the National Office to change their method of accounting subject to the following exceptions:

- Does not apply if the taxpayer is already under examination for any other taxable year on the date of contact by the Service. For example, an examiner is auditing a taxpayer's 1990 Form 1120 and determines that the taxpayer will now be required to maintain inventories of parts and paint. After 90 days the examiner notifies the taxpayer that the 1991 and 1992 Forms 1120 will be picked up for examination. The taxpayer will not be allowed to file the Form 3115 within 90 days after notification of the intent to audit the 1991 and 1992 tax year.

If the taxpayer is allowed to make the change in accounting method himself or herself, the treatment of the IRC section 481(a) adjustment depends upon whether it is a net positive or net negative adjustment.

If the change from a Category A method results in a net positive adjustment, the taxpayer must take the net Section 481(a) adjustment into account ratably over 3 taxable years beginning with the earliest year under examination. If the adjustment is a net negative adjustment the taxpayer would need to take it into taxable income entirely in the year the Form 3115 would be considered timely filed under subsection 5.01 of the Revenue Procedure.

120 Day Window

This window applies to the 120 days following the date an examination ends even though a subsequent examination may have commenced. However, the window will not be available under the following situations:

1. The method of accounting is included as an item of adjustment in a basic report form as a result of a prior examination by the Service or,
2. The method of accounting issue is placed in suspense by the Service or,
3. The taxpayer has received written notification from the examiner (by examination plan, information document request, notification of proposed adjustments, or income tax examination changes) prior to the filing of the Form 3115 specifically

citing the method or sub-method to be changed as an issue under consideration for a taxable year in the subsequent examination.

If relief is available, the year of change for the IRC Section 481(a) adjustment will be considered the taxable year that includes the first day of the 120 day window.

If the change results in a net positive adjustment under IRC section 481(a), the taxpayer must, beginning with the year of change, take the net IRC section 481(a) adjustment into account ratably over 3 taxable years in computing taxable income.

If the change results in a net negative adjustment, the taxpayer must take the entire net IRC section 481 (a) adjustment into account in the year of change.

30 Day Window

This window will be available during the first 30 days of any taxable year if:

1. The taxpayer has been under examination for at least 18 consecutive months prior to such 30-Day window, and
2. The taxpayer has not received written notification from the examiner prior to the filing of the Form 3115 specifically citing the method or sub-method to be changed as an issue under consideration.

If relief is available, the year of change will be considered the taxable year that includes the first day of the 30 day window.

If the Category A adjustment results in a net positive adjustment, the taxpayer must, beginning with the year of change, take the net IRC section 481(a) adjustment into account ratably over 3 taxable years in computing taxable income.

If the Category A method results in a net negative adjustment, the taxpayer must take the entire net IRC section 481 adjustment into account in computing taxable income for the year of change.

Each of these windows may have certain exceptions affecting the usual spread periods. (The \$25,000 de minimis or 90 percent rule.) The examiner should consult the Revenue Procedure to recognize these exceptions and their ramifications.

Chapter 9

EMPLOYMENT TAXES

INTRODUCTION

Employment tax issues were raised and adjustments made in a significant number of the auto body and repair cases examined. The areas of adjustment generally included:

1. Reclassification of worker status from that of independent contractor to employee.
2. Inclusion of employee bonuses and other payments made outside of payroll in the wage base.
3. Inclusion of corporate shareholder salaries in the payroll.
4. Other adjustments, including omission of part of the payroll from the employment tax returns and the deduction of penalties as employment tax expense.

Not all of these employment tax issues are unique to auto body and repair shops and might occur in many other types of moderately sized businesses, but reclassification of workers from contractor status appeared to be far more prevalent on these returns than would normally be anticipated, though the sample taken could not be classed as random.

Our findings were reinforced by those of California's EDD after their sweep of small businesses in the San Jose area made to test compliance with State reporting requirements. A total of 471 businesses with an average of 2.3 employees each were visited in May 1992 and showed the highest rate of nonregistration among the classes of establishments surveyed in San Jose, though agriculture and garment contractors appear to be the worst offenders overall.

The question of whether an individual is an independent contractor or an employee is one of fact to be determined upon consideration of the facts and application of the law and regulations in a particular case. See *Professional & Executive Leasing v. Commissioner*, 89 T.C. 225, 232 (1987), *aff'd* 862 F.2d 751 (9th Cir. 1988); and *Simpson v. Commissioner*, 64 T.C. 974, 984 (1975). Guides for determining the existence of that status are found in three substantially similar

sections of the Employment Tax Regulations; namely, sections 31.3121(d)-1, 31.3306(I), and 31.3401(c)-1, relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and Federal income tax withholding, respectively.

In general, it should be noted that section 3121(d)(2) of the Internal Revenue Code requires the application of the common law rules in determining the employer-employee relationship. In determining whether an individual is an employee under the common law rules, several factors have been identified as indicating whether sufficient control is present to establish an employer-employee relationship. These factors have been developed based on an examination of cases and rulings considering whether an individual is an employee. The degree of importance of each factor varies depending on the occupation and the factual context in which services are performed. See Rev. Rul. 87-41, 1987-1 C.B. 296, where some 20 factors have been identified. These factors are not to be applied blindly. Rather, they are to be used as an aid in determining whether direction and control exists.

Although a variety of factors may be used to analyze employment status for tax purposes, the regulations provide that employer control over the manner in which the work is performed is probably the most important. The test is either actual control by the employer or the right to control.

For further assistance regarding employment tax issue, we suggests that the employment tax coordinator be contacted.

After it has been determined that an examination of the employee/independent contractor issue will be undertaken, section 530 should be addressed as early as practicable. Section 530(a)(1) of the Revenue Act of 1978 terminates an employer's liability for employment taxes under subtitle C, which includes FICA, FUTA, and income tax withholding, any interest or penalties attributable to the liability for employment taxes. Section 530 provides that, for employment tax purposes, an individual will be deemed not to be an employee unless the employer had no reasonable basis for treating the individual as an employee. The purpose of section 530 is to shield employers who had a reasonable basis for treating workers as independent contractors from employment tax consequences arising from employment status reclassification by the Service.

For an employer to be eligible for relief under section 530: (1) all required information returns must have

been filed on a timely basis (for example, Form 1099); (2) the employer must not have treated any other workers holding a substantially similar position as employees after 1978; and (3) the employer must have had a reasonable basis for not treating the workers as employees.

The employer may establish a reasonable basis for not treating the workers as employees by relying on any one of the three safe havens set out in section 530(a)(2):

1. Judicial precedent, published rulings, or a technical advice memorandum or a private letter ruling with respect to the taxpayer; or
2. Prior Service audit of the taxpayer; or
3. A long-standing recognized practice of a significant segment of the industry ("industry practice") in which the worker is engaged.

As early as possible during the examination, it is important to discuss with the taxpayer the reasons the workers were treated as independent contractors. During the discussion, the examiner should keep notes of the taxpayer's responses. A taxpayer cannot have relied on recently decided cases for years prior to the decision. An opinion letter from an attorney written after the examination began is less persuasive than one that was written when the employer first began using the workers and treating them as independent contractors. The taxpayer has the burden of establishing industry practice based on objective criteria substantiated by the taxpayer.

For example, in *General Investment Corporation v. United States*, 823 F. 2d 337 (9th Cir. 1987), the court held that a mining company had a reasonable basis for treating miners as independent contractors because the taxpayer had substantiated that the practice of treating miners as independent contractors was both long standing and well recognized within a significant segment of the local mining industry.

For further assistance regarding section 530 issues, you may contact your employment tax coordinator or the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations) at (202) 622-6040 or (202) 622-6050.

Section 3509 of the Code deals with an employer's liability for failing to withhold income taxes and employee FICA taxes because the employer improperly treated its workers as independent contractors.

Generally, the Service makes assessments under this section as a result of an employment tax examination of the employer's returns.

If an employer improperly fails to treat a worker as an employee, section 3509 of the Code provides that the employer's liability for employee FICA taxes is equal to 20 percent of the employee's normal FICA tax liability, and the employer's liability for income tax withholding is equal to 1.5 percent of the employee's wages. Under IRC section 3509(b) these percentages are increased to 40 percent and 3 percent, respectively, if the employer did not timely file required information returns without reasonable cause.

IRC section 3509 does not apply if the employer's liability is due to the employer's intentional disregard of the requirement to deduct and withhold taxes. IRC section 3509 also does not apply when an employer withholds income tax but does not withhold FICA taxes from an employee's wages. In each case, the employer remains liable for the employer's share of FICA taxes as well as the tax imposed by the Federal Unemployment Tax Act (FUTA).

RECHARACTERIZATION OF PAYMENTS AS WAGES

Employers may seek to classify individuals as independent contractors for a variety of reasons. Chief among these is a substantial savings on employment taxes on the Federal and state level, but other savings and advantages are also factors. The decreased payroll for metal, paint, and mechanical labor, all high risk categories, can sharply decrease workers compensation insurance costs. The absence of employees, other than the corporate shareholder, would allow him or her to establish employee pension and insurance plans with himself or herself as the sole participant. He or she may also be able to hire undocumented workers under such as arrangement at considerably lower rates of compensation than normal.

The employee may report the income, particularly but not always, if Forms 1099 were issued, and then substantially offset the gross with "business deductions" on a Schedule C that might not otherwise be allowable or require that he or she itemize deductions. Coupled with the income adjustments available beginning in 1990 for 50 percent of the self-employment tax paid, this can reduce total tax below the level of the combined FICA and income tax that would otherwise be due. In the case of one reclassified employee, with about \$30,000 per year in gross earnings, claimed

deductions were so inflated the net earnings were reduced to about \$6,000. No income tax was due and earned income was claimed, offsetting the self-employment tax liability. Other employees simply failed to report earnings or file tax returns.

Employees may be found classified as independent contractors consistently, either individually or as a whole, or for only part of the time. Compensation paid and status may also be changed from that of contractor to that of employee or vice versa during the period under examination.

CONSISTENT TREATMENT AS NON-EMPLOYEE

In two cases examined, written independent contractor agreements were maintained with all direct labor. These were standard forms negotiated between the employer and the worker, who usually went under the title of "John Doe Auto Repairs" with names and dates filled in where appropriate. The contracts described the status and the freedom to work for others and required that some tools be supplied by the worker. One set was not timely signed. Most workers were paid on a commission basis, ranging from 40 to 50 percent of the repair charge, and submitted a periodic billing. In neither case did the contracts prevent a reclassification of status to that of employee based on facts and circumstances and industry practices.

It is quite common in auto repair to pay employees a percentage of the billed labor charge in lieu of an hourly wage and to require them to supply their own small tools. The extent of control exercised by the employer is the key to evaluating their status and can be determined by consulting the 20 Common Law Factors. Interpretation of the findings can be aided by referring to a multitude of letter rulings in this area for their interpretation of similar sets of facts and the citations made in support of their findings only.

In several cases the treatment of the individuals was voluntarily changed to that of employee by the employer after the initial examination year, but the level and method of payment and the duties were not. In all cases encountered and adjusted, individuals did not work for other firms during the same period employed by the company under examination.

Other factors that presented themselves in reclassification situations that either tended to prove the employee status or required some special attention are listed below.

1. In the case of one employer, deductions were made from his independent contractor payments for the employee health insurance plan (paid only in part by the employer) and for uniforms. The net check was deducted as an expense on the employer's return and it was necessary to gross up the amounts to compute the employment tax due. Since the allowance of the wages at gross in this case would be offset by a credit to the two expense accounts, no change to deductions on the tax return was needed, but in the case of other deduction, an expense increase may be warranted.
2. Other "independent contractors" were supplied with uniforms and T-shirts with the employer's name emblazoned thereon.
3. Some treated as outside labor were paid an hourly salary and overtime, and received bonuses and advances controlled through the employee advances account.
4. Payments made to non-employees were generally made on the usual company payroll dates.
5. The deduction for payments to non-employees was listed as commission, subcontract, outside labor, or sometimes lumped with labor on the tax return.

OCCASIONAL TREATMENT AS NON-EMPLOYEES

Not all status adjustments made involved individuals who were consistently treated. Many employees were partly compensated as independent contractors with those amounts deducted in a book account identified as commissions, outside labor, or subcontract rather than through the payroll account. The tax returns often followed that classification, but sometimes lumped the costs with labor in the cost of goods sold.

In these cases, no reclassification is necessary, since the individuals are already acknowledged as employees and IRC section 3509 would not apply.

Deductions may have been made from some checks and if they can be ascertained from copies of the checks or stubs, personnel files, vendor files or comparison with regular payroll checks in the case of salaried employees, it will be necessary to gross them up for employment tax purposes. If only the net check was deducted and deductions are for such items as parking, health insurance, or uniforms that would serve to

reduce an expense account, it is not necessary to increase the labor deduction on the employer return since the increase would be entirely offset. If FICA, Federal or state income tax, or SDI is withheld then the gross up of these items should be reflected in the wages deduction allowed on an agreed case. On an unagreed case, a whipsaw position may be advisable if the amounts are at all substantial, allowing only the net amount already deducted.

Instances in which employees were paid as contract labor varied, covering a random pattern for the most part. Most were so compensated for a week or a month, then returned to the regular payroll for a time and then the process repeated. In other cases a check was issued off the payroll for the regular net wages receivable or overtime work was treated as contract labor. Still others received a final check outside of the payroll accounts. One employer kept his employees on the payroll at a reduced rate and paid the balance in cash.

Another business imported workers and treated the undocumented employees as independent contractors until they received green cards and social security numbers. In some cases bills for legal assistance were also paid. One long time employee, an alien whose student visa and work permit expired, continued employment as a contractor.

It is possible that a worker may wear "two hats." That is, the worker may perform more than one type of job with the company and be a common law employee as to one job and an independent contractor as to the other.

BONUSES

In several instances, cash Christmas and other bonuses were found to have been paid to employees, including shareholders, and not included in W-2 wages. In no case encountered were Forms 1099 issued or the income reported, except for shareholder-employee yearend bonuses. In the case of one shareholder, however, an adjustment was necessary where \$42,000 in total bonus payments were received and deducted as bonuses by the corporation, but only the \$5,000 paid him at fiscal yearend was reported as income on his Form 1040.

Unreported bonuses encountered also took the form of an all-expense paid vacation and forgiveness of outstanding cash advances at yearend. The latter expense was taken by journal entry, crediting the asset account and debiting the payroll accounts directly.

Many employers and their employees feel that the Christmas bonuses in the form of cash and awards of trips or other lavish noncash gifts are presents to the employees and not subject to tax. They are equated with the exempt turkey giveaway and employers otherwise complying with the provisions of the law may omit them from the employment tax returns and Forms W-2.

OFFICER SALARIES

Occasionally the corporate officer's salaries do not appear on the Forms 941 or W-2 and are reported on the officer's return as miscellaneous income or gross receipts on Schedule C. Self-employment tax is usually paid, often on an amount substantially diminished by deductions, possibly duplicated on the corporate return, but not limited by the 2 percent Schedule A threshold. The deduction for 50 percent of the self-employment tax can be taken beginning in 1990 and the 25 percent of health insurance cost adjustment may appear as well might a Keogh or SEP deduction in lieu of a lesser IRA deduction where the company has no pension plan.

Because the corporate officer is a statutory employee under Section 3121(d) of the Internal Revenue Code, an adjustment is required to the Form 941 to include the gross salary paid. The Form 1040 may also be affected.

OTHER SITUATIONS

Other issues encountered affecting employment tax returns or deductions included the omission of a bi-weekly payroll from the Form 941, 940, and W-2. The taxpayer used a service to prepare the payroll checks, but the returns were prepared by the accountant, who also then prepared the Form W-2 using the California State Form DE-3 quarterly schedule.

The omission made was a June 30 dated payroll, which had been marked July 1, then forgotten. Deduction for the salaries and tax liability was taken fully using the payroll service figures.

The payroll tax reconciliation showed Form 941 wages and tax slightly lower than Form 1120 wages and tax for a variety of reasons, but the single missing pay period resulted in only a 4 percent wage variance. Since the taxpayer reported his income and expenses on a cash basis, and he was in his initial year of business, and had paid his DE-3, 940, and part of his 941 liability

after year-end, the apparent variance was further diminished. Pursuit of an explanation for the relatively small differences in this case resulted in a fairly substantial adjustment, no portion of which is subject to abatement.

In several cases, adjustment was made to deductions where FTD (Federal Tax Deposit) penalties asserted were deducted as payroll tax or interest expense.

EXAMINING RETURNS, BOOKS AND RECORDS

Employment tax issues often present themselves early in an examination, beginning with the initial review of the tax return. Any indications detected before the initial interview will enable an examiner to better tailor his or her questions to cover the issues and make observations that will assist the examiner later. Some clues that may be encountered are discussed below in the order that they are likely to be seen.

The Tax Return

The cost of labor shown on the Schedule A may appear low relative to inferred nontaxable sales. Although such a sales figure is not shown on the tax return, it can be very roughly approximated by subtracting 125 percent of the purchases and sublet from sales. Since a body or repair shop generally tries to keep labor costs down to 40 percent of sales, a much lower figure could indicate a problem. If the shop is small and the owner performs services, allowance must be made to include their value in the computation.

One should also look for a relatively large deduction for the cost of outside labor, contract labor, or commissions on the other cost detail for Schedule A at the same time. A combination of low wage costs and a high commission expense would serve to increase suspicion of an employment tax issue.

Check the payroll tax expense if it is shown on the detail attached to the return for Schedule A or taxes expense. It should bear a reasonable relationship to total wages considering the rates for the year. If the amount is lower than would be expected, labor costs, other than wages are probably included in the costs shown on the return.

Transcripts

Sometimes the expense of contract labor is shown as salaries and wages as part of the cost of goods sold,

and if employment tax is not detailed on the return or appears to be low relative to the wages shown, transcripts of the returns can be useful. Currently employment tax transcripts show total compensation as well as FICA wages and a review of those covering the year under examination can tell you if any substantial payments made to individuals treated as non-employees are included in labor costs.

If policies changed and the employer began to treat his or her former contractors as employees, as was the situation in two of the cases examined during this study, transcripts covering the period of change will indicate that change. Be aware, however, that opening a second site or expansion could also cause a sustained payroll increase and bonuses to shareholders are often reflected by a quarterly increase.

If you obtain transcripts also note if penalties have been assessed during the period since they are often deducted. In corporations an M-1 adjustment should be shown if penalties were incurred during the period.

Reconciliation and Forms W-2 and 1099 Inspection

Standard package audit techniques should always be applied and any unreconciled differences remaining should be explained. The previously mentioned omission of a pay period from the employment tax returns was located by using a quarterly rather than an annual reconciliation format, which proved to highlight the areas requiring adjustment.

The reconciliation will also show if bonuses and officer salaries are included in the employment tax returns, if bonus expense is listed separately. Bonuses included in wage expense but not included on the Form 941 will, of course, result in an unreconciled variance.

Difference in the employment tax liability, after accrual and other adjustment are made could be accounted for by the aforementioned inclusion of penalties and interest or payment of Federal and state back taxes.

Once the reconciliation is complete, Forms W-2 and 1099 should be compared to see if the same individuals were treated as both employees and non-employees. This can be accomplished at the same time as the normal compliance checks. Note also substantial sums paid to individuals. Total figures on the Form W-3 should match the unadjusted Form 941 totals.

Disbursements

Not all Forms 1099 may have been filed as required and some payment totals may not have reached the \$600 threshold (for example, \$500 bonuses paid employees), so it is necessary to scan cash disbursements for payments made to employees and for regular and repetitive payments to non-employees. This is something that should be done, anyway, as part of a compliance check.

Repetitive payments to individuals and payments made to employees, other than reimbursements and advances, should be noted and checked even if a Form 1099 was issued. The schedule should show the date, check number, and amount of **each** payment. If the individual receiving payment is an employee, the schedule can be compared to payroll records to see if he or she was issued a regular payroll check that week. For both those treated as employees and contract labor, such a schedule shows regularity of payments, the need for full time work during the period employed, the days payments were made (is it the company's normal pay date?) and of course the total paid for the year.

Checks and stubs can be examined before or after scheduling to verify endorsements -- that is, by an individual or by John Doe d.b.a. Super Glass -- and check for notations as to the purpose of the payment and any withheld amounts. Where no Form W-2 or Form 1099 is issued, endorsements may also give you enough information to identify the individual with certainty through an address or drivers license number and obtain a social security number.

A personnel or vendor file may also be maintained to provide additional data on the reasons for payments and deductions from the gross, if any.

Related Returns

Normally copies of the corporate officer's returns will be supplied, but to inspect employee or independent contractor returns, a facsimile can now be obtained quickly on IDRS using the RTVUE command. This will show the reported amounts of miscellaneous and Schedule C income and can be compared with the scheduled amount paid. It can also be useful in determining whether the individual worked for others if the payments from the taxpayer spanned a calendar year.

PENALTIES

Failure to Deposit - IRC section 6656: This is a 10 percent penalty applicable only to the employer paid portion of the tax. This means the employer's share of the FICA and all of the FUTA.

Delinquency - IRC section 6651: If the employment tax returns were filed late, delinquency penalties are applicable as with any other tax. A transcript should be consulted.

Negligence - IRC sections 6653(a) through 8909, IRC section 6662 for 8912 and thereafter: Since the Tax Reform Act of 1986, negligence has been applicable to employment taxes. Prior to that Act there was no provision for the application of the penalty.

Fraud - IRC section 6663 for returns due after December 31, 1989, IRC section 6653(b) for returns due prior to that date: Though applicable to employment tax returns, the same burden of proof as to intent exists as with an income tax case.

BACKUP WITHHOLDING

Backup withholding should be considered where no Forms 1099 are issued or identifying numbers supplied and the individual is **not** an employee. The issue is fully discussed in another section, but merits mention here because backup withholding is treated as an employment tax and reported on the Form 941. It is subject to the same statutes as the employment taxes even if no Forms 1099 were filed.

STATUTE AND CLOSING PROCEDURES

The normal statute date for timely filed Forms 941 for all quarters of a calendar year is April 15 of the fourth succeeding year, regardless of the due date of the quarterly return. For example: the normal statute date for all 1990 quarterly Forms 941 is April 15, 1994. If it is later, the statute expiration date of delinquent returns is 3 years from the filing date.

The statute date for Form 940, FUTA, is 3 years from the due date or filing date, whichever is later. Since the due date for filing the Form 940 is January 31 of the year following the calendar year, the expiration date for a timely filed 1990 return is January 1, 1994.

Both the employment tax return and employee FICA statutes are extended using Form SS-10.

There is no statute date for unfiled returns, but transcripts must be secured and substitute procedures followed to process adjustments in such cases. A return filed showing no liability for the quarter, is sufficient to start the running of the statute.

Unagreed cases receive a 30-day letter but are not subject to deficiency procedures as are income tax cases. If there is no response to the 30-day letter, or if the taxpayer declines to execute a necessary extension of the statute, the case is defaulted and the taxpayer is billed. The taxpayer's only recourse after the assessment is made is to pay a portion of the tax and file a claim for refund.

When agreement to adjustments made to a previously filed return is secured on Form 2504, the taxpayer is entitled to relief from accumulated interest under IRC section 6205. It is necessary to note the Code section and the type of tax on the Form 3198. Interest will begin to accrue, however, if the tax is not paid by the due date of return for the quarter in which consent was secured.

It should be noted that the determination of an employer-employee relationship may affect other areas of Federal law. For example, the Supreme Court held in *Nationwide Mutual Insurance Co. v. Darden*, 112 S. Ct. 1344 (1992), that the term "employee," as used in the Employee Retirement Income Security Act, incorporates traditional agency law for identifying master-servant relationships.

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Chapter 10

INFORMATION RETURNS/PENALTIES

FORM 1099 INFORMATION RETURNS

The specialized nature of an auto body shop dictates that many of the services needed to restore a vehicle are performed outside the shop. Per IRC section 6041, those who operate a trade or business and make payments of rent, salaries, wages, and other compensations of \$600 or more for a calendar year are required to file information returns to report such payments.

Generally, per Treas. Reg. section 1.6041-3, payments of \$600 or more to a corporation are usually excluded from Form 1099 reporting. If a question arises as to the operating form of the payee, various sources may be consulted. The invoices or cancelled checks paid to the entity may provide a clue. Correspondence is also another source. If it is determined that rent is required to be reported, the lease may provide the operating form. If none of the above sources provides the operating form, it is the taxpayer's burden of proof to show that a Form 1099 statement was not required to be filed.

The examiner must be aware of the potential of the information return test work because it can often lead to significant tax dollars which the primary return (corporate, partnership, or individual) may not produce. Large adjustments can be produced through back-up withholding, return penalties, and even on the returns of the payees who were required to report the compensation but did not receive information returns.

Many services provided to the auto body shop require the filing of a Form 1099 statement. A few are shown below but the listing should not be considered exhaustive. An examiner should always consider whether an information return is required on a case by case basis.

1. **Towing Fees:** An auto body shop utilize several towing companies during the course of a year. These towing fees often exceed the \$600 minimum.
2. **Detailing Costs:** Body Shops will often take the completed vehicles to get washed and waxed.
3. **Pin Striping:** This is a specialized paint service which is often performed by separate entities.

4. **Auto Repair Services:** This involves mechanical labor used to tune up a vehicle and provide other services. The sale of merchandise is not required to be reported via Form 1099 statement.
5. **Janitorial/Gardening:** Some body shops maintain very clean premises and surroundings to present a better image. This often requires the use of individuals on a consistent basis.
6. **Accounting Services:** Many shops utilize independent bookkeepers and accountants to do the monthly entries, prepare sales tax and employment tax returns, financial statements, and information returns.
7. **Lease Agreements:** Body shops often lease the premises for the shop.
8. **Interest:** In Corporate cases with bona fide loans to shareholders Form 1099-Int statements should be prepared for the interest payments made.
9. **Finder's Fee:** In one case, it was determined that an auto body shop was paying fees for referrals.
10. **Auto Body Labor:** In some case, workers may be true independent contractors or the taxpayer may actually sub-contract overflow work. In these cases, Form 1099 statements are definitely required.

AUDIT TECHNIQUES

Many of the steps mentioned here will take quite a bit of time to complete. However, because of the size of potential adjustments it is worthwhile.

1. **Request proper information:** To simply request the Form 1099 statements prepared for calendar year is usually not sufficient. The Form 1096, Annual Summary and Transmittal of U. S. Information Returns, should also be requested since this summarizes the number of Forms 1099 prepared and submitted to the particular service center responsible. If there were any schedules prepared by the accountant or taxpayer to compute the Forms 1099, these should be requested as well since they often facilitate the audit work. If no schedules were prepared, then the cash disbursements journals which encompass the calendar year should be requested.

2. Accuracy Test:

- a. The total number of statements filed per the Form 1096 Transmittal should be reconciled to the Form 1099 statements. This allows the examiner to determine whether any Form 1099 statements are missing.
- b. If a payment schedule has been provided, compare the amounts on the schedules for selected individuals against the amounts on the Form 1099 statements. In some cases, individuals were included on the schedule but no Form 1099 statement was filed. Follow up by the examiner revealed that Form 1099 was required. In other cases, the schedule was mathematically inaccurate.
- c. To determine whether the Form 1099 amounts are correct, select a few individuals and compare the payment schedules with the cash disbursement journals for the related years. If no payment schedules are available then add up the payments in the cash disbursement journals made payable to the individual.
- d. If there are any doubts about the actual filing of the Forms 1096 and Forms 1099, a Payer Master File on Line (PMFOL) can be obtained via IDRS. Consult the current ADP and IDRS Information handbook for information.

3. To test for nonfiled Form 1099 statements:

If the taxpayer has not filed any Form 1099 statement at all, then the examiner will need to examine the general ledger and/or disbursement journals for any payments which appear to be service related. If the general ledger accounts are detailed, then account descriptions such as "Towing," "Sublet," "Legal and Accounting," "Commissions," "Rent," and other service type accounts should be especially screened.

In cases where Form 1099 statements have been filed the examiner should be alert for omitted vendors. In this case the cash disbursements journal should be scanned with the Form 1099 statements handy. Any vendors paid through service type accounts should be noted if paid over \$600 and a Form 1099 statement not issued. Consistent omissions of large amounts should be considered for intentional disregard penalties.

The taxpayer's reason for not preparing the statement should be requested. If the taxpayer claims that the payee is exempt due to corporate status, request the documents upon which the taxpayer based this determination (Form W-9, correspondence, invoices, etc.)

4. **To test the accuracy of the payer's and payee's identification:**

The Form 1099 statements should also be examined for incomplete or inaccurate identifying information. Both the payer's and payee's complete name, address, and Federal TIN are required. Due to Treasury Decision 8365 issued in C.B. 1991-2 373, sole proprietors are allowed to furnish either their SSN or their EIN. In addition, the Treasury Decision goes on to state that a sole proprietor may not furnish only a business name. If the TIN is incomplete or omitted then backup withholding may apply.

5. In the event that Form 1099 statements have not been filed or issued, the examiner should consider the possibility of a related pickup. Although some research may be required to track down the payee, with the advent of the new Return Transaction File (RTVUE command) on IDRS, it may be a simple matter to determine whether the income was included. With this command, major components of an individual's Form 1040 return can be viewed (that is, Schedule C, SE etc.). Consult the current ADP and IDRS Information handbook for access to the command.

Other Issues

While scanning Form 1099 statements, be wary of any names which also appear on payroll information such as Form W-2 statements and/or payroll journals. In one case, the taxpayer was treating his workers as independent contractors during the first 3 quarters of the year. The taxpayer subsequently moved and converted several of the workers to employee status. The same names on both Forms 1099 and Form W-2 led the examiner to question the independent contractor status. An adjustment was subsequently made to the employment tax returns under IRC section 3509(a).

FORM 8300 INFORMATION RETURNS

Per IRC section 6050I, any person engaged in a trade or business and who, in the course of such trade or

business, receives more than \$10,000 in cash in one transaction (or two or more related transactions), shall be required to file a Form 8300 with respect to the transaction(s).

The information required to be shown on such form includes:

1. The name, address, and TIN of the person from whom the cash was received,
2. The amount of cash received, and
3. The date and nature of the transaction.

The form 8300 is to be filed with the Internal Revenue Service by the 15th day after the date the cash payment is received.

With some of the larger auto body shops, cash is a definite possibility as a means of payment not only for the repair of a vehicle but also for the sale of vehicles which have been purchased or taken by lien and restored.

Package Audit Requirements/Audit Techniques

One of the steps required to be performed during an audit is mandated by RC-W Memorandum 42-56 dated March 1, 1988. It contains the following requirements:

1. All business taxpayers must be notified in writing of the Form 8300 filing requirements.
2. The Currency and Banking Package Audit Checksheet must be completed in duplicate for all business taxpayers. These completed checksheets should be given to the group secretary who will mail them to the appropriate processing groups.

These requirements should be followed by the following recommended audit techniques to test compliance. These audit steps are by no means comprehensive and should be supplemented according to the judgment of the examiner.

1. The examiner should inspect the taxpayer's retained copies of Form 8300, along with the annual statements required to be furnished to the "identified person." If the taxpayer under examination is the "identified person" on the Form 8300, the examiner should use IRP transcripts to identify other potential unreported income.

2. An inquiry should be made on the Currency and Banking Retrieval System. This is suggested to determine if the business has a high currency transaction report history.
3. Bank deposit slips should be requested and a review made. Cash deposits should be particularly noted. The particular date and the amount of each cash deposit should be listed. A certain criteria should be set for cash deposits to be listed such as \$5,000. The reasoning behind this is that individuals may be aware of the \$10,000 criteria and set up the transaction to avoid the reporting requirements.
4. Request the cash receipts journal to cross reference the taxpayer's customers's names to those days selected in step 3. Once the customer's name has been selected, a request should be made for the customer file or the invoices to which the transaction is related.
5. The examiner should also be aware of possible unreported income when he or she is cross referencing from deposit slips to cash receipts journal or vice versa.

It should be noted that recent and important changes have been made with regards to the Form 8300. The most important change is in regards to the definition of "cash." Per Treas. Reg. section 1.6050 I-1(c)(1), the definition of "cash" changes depending upon when it was received by the taxpayer. It is defined as follows:

1. For amounts received prior to February 3, 1992, "cash" will be defined as the coin and currency of the United States or of any other country, which circulate in and are customarily used and accepted as money in the country in which issued.
2. For amounts received on or after February 3, 1992, the term "cash" will include the definition stated in (1) as well as a cashier's check (by whatever name called, including "treasurer's check" and "bank check"), bank draft, traveler's check, or money order having a face amount of not more than \$10,000 received in a designated reporting transaction or received in any transaction in which the recipient knows that such instrument is being used in an attempt to avoid reporting. (Treas. Reg. section 1.6050 I-1(c)(1)(iii)). (A designated reporting transaction is a retail sale of a consumer durable, collectible, or a travel or entertainment activity.)

A Currency and Banking Retrieval System query is required when the examination involves a business return, (All Forms 1120, 1120-S, 1065, and all Form 1040 Schedule C and F returns).

PENALTIES

The Revenue Reconciliation Act of 1989 did a complete overhaul of the civil penalty system as it stood before. It restructured and simplified some of the penalty sections and gave other sections escape clauses and penalty reductions if the errors were corrected during a specified time period. These provisions apply to returns required to be filed after December 31, 1989 (without regard to extension).

One of the simplifying steps was to condense the penalties into one area involving information returns.

The two primary Code section which relate to the auto body industry are IRC sections 6721 and 6722. IRC section 6723 is applicable to situations which involve information on returns other than information returns or payee statements.

Failure to File Correct Information Returns -- IRC section 6721

Applicable to Form 1099 statements required for 1989 and subsequent.

An "Information Return" is defined in IRC section 6724(d)(1). Generally it will apply to auto body shops in regards to Forms 1099-Misc, Forms 1099-Int, Form W-2 statements, and Forms 8300.

This penalty will cover the following situations:

1. The payer fails to file information return before required filing date
2. Payer fails to include all information required to be shown on return or the inclusion of incorrect information.

The penalty now has a three tiered structure depending upon whether the taxpayer corrects the errors within a certain time period. The penalties are applicable as follows:

1. If the failure is corrected on or before the 30th day after the required filing date, the penalty

will be \$15 per failure with the total penalty not to exceed \$75,000 for the required filing calendar year.

2. If the failure is corrected on or before August 1 of the calendar year in which filing is required, the penalty will be \$30 per failure with the total penalty not to exceed \$150,000 for the required filing calendar year.
3. If the failure is corrected after August 1 then the penalty will be \$50 per failure with the total amount not to exceed \$250,000 for the required filing calendar year.

De Minimis Rule: If the filed return did not include the correct information and the failure was due to reasonable cause and not to willful neglect, if the correction is made on or before August 1 of the required filing calendar year, no penalty will be asserted.

For any calendar year, the number of information returns to which the de minimis rule applies may not exceed the greater of: 1) 10; or 2) one-half of 1 percent of the total number of returns required to be filed during the calendar year. If the total number of returns corrected by a taxpayer exceeds the de minimis limit, only the number exceeding the limit is subject to penalty.

Any failure with respect to information returns is subject to a harsher penalty if the failure is due to intentional disregard of the filing or correct and complete reporting requirements. When intentional disregard is applicable, the de minimis rule is not and the calendar year maximum penalty amounts do not apply

Intentional Disregard: If the penalty is due to intentional disregard, the penalty for each failure is the greater of 1) \$100; or 2) 5 percent or 10 percent of the aggregate amount of the items required to be reported correctly, depending on the type of information return.

Failure to Furnish Correct Payee Statements -- IRC section 6722

This penalty is applicable to the following situations:

1. Failure to furnish a payee statement on or before the date prescribed, to a person to whom such statement is required to be furnished or

2. Failure to include all the information required to be shown on a payee statement or
3. Any inclusion of incorrect information on a payee statement.

The penalty amount is \$50 for each statement with respect to which a failure occurs, the total amount not to exceed \$100,000 for a calendar year.

Intentional Disregard: If the penalty is due to intentional disregard, the penalty for each failure is greater of 1) \$100; or 2) 5 percent or 10 percent of the aggregate amount required to be reported correctly depending on the type of the payee statement.

BACKUP WITHHOLDING

One of the major compliance tools to consider in the event no Form 1099 statements were issued when required or were issued with no payee TIN is the backup withholding provision of IRC section 3406. Backup withholding can be applied in conjunction with the above penalty sections.

If an individual is subject to backup withholding and amounts are not withheld, the payer becomes responsible and liable for the tax. At 20 percent (31 percent beginning in 1993) of the amount of compensation paid, this can result in substantial assessments. The assessment can, however, be abated by proving that the income tax was paid on the compensation by the payee.

Beginning with reportable payments made after 1983, the payer was required to withhold 20 percent of such payment unless:

1. The payee was exempt from withholding or
2. The payee has satisfied requirements of IRC section 3406 (a)(1) or
3. The payment is subject to some other withholding provision.

In the case of exemptions for payees, this would include payments to corporations, financial institutions, tax exempt entities, governmental entities, and international organizations. Independent contractors will fall under an exempt status only if organized as corporations.

A reportable payment subject to withholding follows the criteria for Information Reporting as set forth by IRC section 6041(a). That is, a payment for compensation to a non-employee from a trade or business aggregating \$600 or more for one calendar year.

IRC section 3406 as it applies to independent contractors involves two primary criteria: In the case of any reportable payment:

1. The payee fails to furnish his or her TIN to the payer in the manner required or
2. The Secretary notifies the payer that the TIN furnished by the payee is incorrect. Then the payer shall deduct and withhold from such payment, a tax equal to 20 percent (or 31 percent) of such payment.

The first step in determining whether backup withholding should be applied lies in the package audit steps. All Forms 1099 should be secured as outlined in the previous sections. Backup withholding may apply in the following situations.

1. A required Form 1099 was not filed, no TIN was requested or was not supplied and no backup withholding was deducted and deposited from the payee payment or
2. No TIN was obtained or requested, no backup withholding was deducted and deposited but a Form 1099 statement was filed anyway or
3. Forms 1099 were filed with incorrect TINs, no backup withholding was deducted and deposited after notices were sent to the payers about incorrect TINs.

To determine whether any of the situations mentioned above occurred, inquiries must be made of the taxpayer as to what steps were taken and what was the response regarding any request. Even though the taxpayer may be not be subject to backup withholding, they still may be subject to the previously discussed information return penalties.

Backup withholding under IRC section 3406 is asserted on the Forms 941 for the applicable quarters of payment similar to employment taxes. However, in some cases, the penalty may be asserted in the quarter of the calendar year.

Abatement Procedures for Backup Withholding

This section is provided to point out to the examiner that procedures have been established to handle abatement requests. Once the issue has been raised, taxpayers will often request that the assessment simply not be made by the examiner if a TIN can be provided currently. It should be noted that the IRM grants the examiner the power to forego the assessment (with concurrence from the manager) if the taxpayer can provide evidence to show that the income was reported and the taxes due were paid. The burden is on the taxpayer to provide such proof. IRM 4696.1 states that evidence would be a copy of the recipient's income tax return clearly identifying the reportable payment in question, which has been compared with a transcript on file.

If the taxpayer cannot provide such evidence currently then he or she must go through the formal abatement procedures by filing Forms 4669 and 4670 with the appropriate Service Center. These Forms should be mailed to the Service Center and not to the examiner.

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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 40 percent. the insurance company may decide that they are only responsible for 60 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 treatment, 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 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 where by the insurance company or the auto body shop 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 autobody 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. 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 tear down 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 .2 hours to remove a section of a vehicle to work on parts A, B, and C. It then takes 1 hour to replace part A, 1 hour to remove part B, and 1 hour 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 panel, 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 vs. 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 automobile 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 asses 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.