Chapter 4

Industry Issue Techniques

Entity, Tax Year, and Accounting Method Issues	As noted in Chapter 2, the taxpayer has many choices in setting up their business. Look for the following issues:
A. Personal Service Corporations	Rev. Rul. 91-30, 1991-1 C.B. 72, holds that a corporation whose employees perform veterinary services is a "qualified personal service corporation" (QPSC) under IRC sections 448(d)(2) and 11(b)(2). 1. Was 35 percent corporate rate used? 2. Calendar year required unless permission received. 3. Were Passive Activity Losses limited?
B. Determination of a Tax Year	1. Substantial Business Purpose Determined? 2. Form 1128 filed? 3. Permission received? 4. For which year is it applicable?
C. Method of Accounting	If the taxpayer is using a cash or hybrid method of accounting, determine whether the taxpayer is required to use inventory accounting; that is, whether the production, purchase, or sale of merchandise is an income producing factor in the taxpayer's business. If so, the taxpayer must use an accrual method for purchases and sales of such merchandise and any related services. 1. **Is merchandise an element in the taxpayer's business?** Based on the regulations and the case law, the Service has determined that for purposes of Treas. Reg. section 1.471-1, merchandise is property transferred to a customer (including property physically incorporated in that which is transferred to a customer), whereas materials and supplies are property consumed during the production of property or provisions of services.

2. **Is it income producing?**

   There is no Service or judicial bright line test regarding when the production, purchase, or sale of merchandise will be regarded as an income producing factor in a taxpayer's business. In the case of a taxpayer providing both merchandise and services, the courts have generally compared the cost of the merchandise purchased to gross receipts. Whether the resulting percentage indicates that merchandise is an income producing factor in the business of a specific taxpayer is based on the taxpayer's unique facts and circumstances.

   If we look to *Wilkinson-Beane, Inc.* v. *Commissioner*, 420 F.2d 352, 354 (1st Cir. 1970), to assist in determining the impact the sale of inventory has on the business, then merchandise with a cost of approximately 15 percent of gross receipts will be regarded as an income producing factor in the taxpayer's business. As a result, generally conclude that merchandise is an income producing factor when the cost of merchandise as a percentage of gross receipts (on a cash basis) is 15 percent or more.

   In summary, we need to exercise discretion before requiring a taxpayer to use the accrual method because the taxpayer has some merchandise that is income producing. The merchandise must be more than some *de minimis* amount.

3. **Valuation of beginning and ending inventories.**

   If you determine that the taxpayer is required to account for inventories and the taxpayer has no records that indicate the beginning and ending inventory values, have the taxpayer conduct a current inventory. Question the taxpayer closely as to any extraordinary circumstances that might have affected this value during the year under examination. If no usual circumstances exist, then use the current value as both beginning and ending inventory value.

4. **Changing a taxpayer's method of accounting.**

   Rev. Proc. 97-27 provides procedures for taxpayers to obtain the consent of the Commissioner to voluntarily change their method of accounting. A taxpayer that is under examination

may not request to change its method of accounting under Rev. Proc. 97-27 unless the taxpayer is eligible to request a method change within either the 90-day window period provided in section 6.01(2), or the 120-day window period provided in section 6.01(3), or the taxpayer obtains the district director's consent, as provided in section 6.01(4).

A taxpayer is not eligible to request a change in method of accounting under either the 90-day or 120-day window periods if that method of accounting is an issue the examiner has placed in suspense or is an issue under consideration. To place a method of accounting for an item "under consideration" for purposes of Rev. Proc. 97-27, give the taxpayer written notification specifically citing the treatment of the accounting item as an issue under consideration. See section 3.08 of Rev. Proc. 97-27 for examples. A sample notification letter to place an accounting method for an item under consideration, for purposes of Rev. Proc. 97-27, is provided as Exhibit 4-1.

In summary, once an examiner decides to examine a taxpayer's method of accounting, the examiner should issue written notification to the taxpayer placing the accounting method issue under consideration as soon as possible. Once the examiner has placed an accounting method for an item under consideration (or in suspense), the taxpayer will not be eligible to request a change in method of accounting under the provisions of Rev. Proc. 97-27.

If a taxpayer under examination is not eligible to change an accounting method under the provisions of Rev. Proc. 97-27, the examiner may require the taxpayer to change from an improper method to a proper one. A change in method of accounting made by a district director resulting in a positive IRC section 481(a) adjustment will ordinarily be made in the earliest taxable year under examination with the entire amount of the IRC section 481(a) adjustment included in the Service's computation of the taxpayer's taxable income for the year of the method change.

Balance Sheet Issues

The general audit techniques in Chapter 3 cover basic balance sheet issues; however as noted below, there are specific issues that are found in this industry.

A. Intangibles

1. **Customer records**

Customer records usually include the patient's medical history, a record of visitations, treatments performed by the medical practice, test results, charts, X-rays, as well as other billing information. The cost of creating and maintaining such a record is expensed as part of salaries, supplies, and other incidentals that are allowed as ordinary and necessary business expenses under IRC section 162.

Often, when a practice is sold, a value is assigned to the medical records and the purchasing party either depreciates or amortizes the records over a period of time (which is usually straight-line for 60 months). These records are intangibles within the meaning of IRC section 197 and are subject to the 15-year amortization rules discussed earlier. For acquisitions made prior to the enactment of IRC section 197, see the intangibles discussion in Chapter 3, section I.

2. **Covenant not to compete**

There are several interchangeable titles for this intangible, namely: restrictive covenants, noncompetitive clauses, and the one most commonly used in IRS literature, "covenant not to compete." Covenants are not unique to the industry. There is, however, one unique factor which should always be considered when this intangible is present. State laws may prohibit the restriction of a veterinarian's practice. In those states, the enforceability and value of a covenant not to compete would be questionable at best. The Industry Specialization Program paper for all industries on covenants not to compete, issued on February 19, 1996, should also be consulted when developing a covenant not to compete issue.

3. **Purchase of a veterinarian practice**

An issue that may be present is the over valuation of tangible assets and the under valuation of intangible assets, which accelerates the taxpayer's recovery of its costs through

depreciation deductions for assets with shorter recovery periods. A change to the allocation of basis between intangible and tangible assets, the result of which simply changes the time or period over which the costs of the assets are recovered or taken into account, is a change in method of accounting to which the provisions of IRC sections 446 and 481 generally apply.

B. Loans to Shareholders

As with other closely held corporations, loans to shareholders have potential for audit adjustment to both the corporation and the shareholder. Loans to shareholders may include advances paid in varying amounts over a continuing period. The personal expenses of the shareholder paid by the corporation may be charged to the account. In many instances, there may be no interest charge. Loan agreements should be reviewed to determine if a bona fide creditor-debtor relationship exists between the corporation and the shareholder.

1. **Potential imputed interest**

   Adjustment per IRC section 7872. Check to see if the balance is $10,000 or greater (the *de minimis* threshold amount) on each and every day of the year before applying IRC section 7872. The *de minimis* exception does not apply where tax avoidance is a principal purpose of the below market loan.

2. **Loan or a dividend distribution**

   Beginning and ending balances should be verified to determine if a pattern of continually increasing balances is occurring. Even when bona fide loan agreements exist, such increases may represent dividends to the shareholder. If a distribution that was originally classified as a loan is in fact deemed not to be a bona fide loan, the amount will be considered to be a constructive dividend.

Income Issues

Most health care providers receive the majority of their income from third party payers (insurance companies). Veterinary service is one of the exceptions. Customers, for the most part, are responsible for making payments directly to the veterinarian for services performed. Large numbers of these small animal and mixed animal customers may pay for their services in cash.

Audit experience indicates than many veterinarians maintain computerized billings and cash receipt information which can quickly and accurately provide information as to any customer's balance. This information is typically maintained on site and can be produced in many ways; that is, cash receipt's journals segmented by day, week or month; customer ledger cards detailing individual charges; payments and adjustments; or accounts receivable lists. In spite of the modern record keeping systems available, many choose to report gross receipts per the bank deposit method. When cash is not deposited or when checks are cashed or deposited into an account other than the business account, this method of reporting income is not accurate.

Interviews with return preparers of taxpayers who have been found to understate income in this way indicate that they were unaware of the computerized record keeping systems. Most preparers provide only year end compilation rather than complete financial services to veterinary practices. They have indicated that they question their clients as to their deposit characteristics and are told that all gross receipts are deposited into the business bank account. The preparer then uses the bank statements to report income. Rarely are any adjustments made to the gross deposits shown on the bank statements.

Check for unreported receipts. Many personal checks are received as payment for services. If the practice is a corporation or sole proprietorship, many of the checks will be made to the veterinarian personally. It would not be difficult to cash these checks or divert them into personal bank accounts.

Due to the nature of the business, the veterinarian can easily divert business income from being deposited into the business bank account(s) and from being reported on the tax return. Therefore, it is imperative that each examination includes the veterinarian's personal bank accounts and an evaluation of their financial status.

A. Gross Receipts

1. Analyze the duplicate deposit slips; generally there should be frequent and significant cash deposits.
2. Analyze the day sheets. The total collections per the day sheets should equal the gross receipts per the tax return.

3. Analyze the customer account ledger cards, selecting a sample and tracing the entries on the customer account ledger cards to the day sheets.
4. Analyze the charge slips. It is possible for the veterinarian to pull the customer account ledger cards that he or she doesn't want the examiner to see.
5. Analyze the appointment book and/or sign in sheet. If these books show that 25 customers came in on a certain day, there should be 25 charge entries on the taxpayer's day sheets.
6. Analyze business cash pay-outs. Verify that the income was reported before it was paid out for business expenses.

B. Additional Income Issues

1. **Sale of veterinarian practice**

Many issues can arise from the sale of a medical practice. Among them is how the outstanding accounts receivables are handled. At the time of the sale they should be considered income to the corporation and a dividend to the shareholders. The contract for sale must be secured and inspected in order to consider the various issues that may be present. Look to IRC sections 301(c) and 311(b).

2. **Passive income recharacterization**

a. Per IRC section 469(a)(2)(B), a PSC cannot offset passive losses against their active income.
b. Self-Rented Real Estate --
> Does the taxpayer materially participate in the entity renting from the taxpayer?
> Is the entity renting the property anything other than a C Corporation?
> If the corporation rents its building from a shareholder, determine whether it is under a net lease (corporation pays most of the expenses except interest, taxes, and depreciation).

If each answer is "yes" the rental income should be treated as nonpassive and not be reflected on Form 8582.

Additional Considerations:
> Is rent at a fair market value?
> Is subletting recorded as income on the tax return?
> Is there any personal use of the building space?

c. Self-Rented Equipment
> Is rent at a fair market value?
> Is there any personal use?

Reminder: Bare equipment leases are subject to self-employment tax. IRC section 1402(a)(1) excepts real estate, but not bare equipment leases. Also, see *Carl and Floy M. Stevenson* v. *Commissioner*, T.C. Memo., 1989-357, CCH 45,857(M) 57 TCM1032.

d. Self-Charged Interest
> Did the taxpayer loan money to a flow-through entity?
> Did the entity pay interest to the taxpayer and claim a deduction for interest expense for all or part of the amount paid?
> Did the entity use any part of the loan proceeds in a passive activity?

If each answer is yes, the taxpayer has self-charged interest income and should be recharacterized from portfolio income to passive income per Treas. Reg. section 1.469-7(a)(1)(i) and (c). Be aware that the flow-through entity (not the taxpayer) can elect out of this treatment and, if elected, the shareholder is denied the right to recharacterize the portfolio income as passive income.

e. Look to the veterinarian's Form 1040. Since many veterinarians own the building their practice is located in, any flow-through rental income must be characterized as non-passive.

Expense Issues

When examining expense issues, there are several factors to keep in mind: are they ordinary, are they reasonable, and for corporate officers -- is there a corporate policy on reimbursement? Research into each of these areas has derived some additional explanations as to the meaning of each.

The principal function of the word "ordinary" in IRC section 162(a) is to clarify the distinction between expenses which are currently deductible and expenses which are capital in nature. See *Indopco, Inc.* v. *Commissioner*, 503 U.S. 79 (1992).

When applying the reasonableness standard, take into account *Robert N. Noyce and Ann S. Bowers Noyce* v. *Commissioner*,

97 T.C. 670 (1991). In this case the judge agreed that the "reasonableness" standard only applies to unreimbursed expenses other than depreciation. Depreciation is not subject to the reasonable standard because it is not deducted under IRC section 162 and therefore does not have to meet the requirements of that section.

As to corporate policy, Rev. Rul. 57-502, 1957-2 C.B. 118, holds that there must be a written resolution requiring the assumption of expenses by the corporate officer in order to allow unreimbursed expenses, otherwise deductible, to be personally deducted by a corporate officer.

A thorough investigation of the facts and circumstances will be needed in each case.

A. Lease Versus Purchase

In a veterinarian practice, many assets can be leased rather than purchased; that is, tables, chairs, desks, x-ray equipment, etc. Many lease agreements have an option to purchase the asset(s) at the end of the lease term for $1.00. These types of leases should be treated as a purchase and the assets should be depreciated by the veterinary practice.

Court cases and IRS rulings have reached determinations on whether a lease is a "valid" lease based on the substance and not the form of the transaction. See *Lockhart Leasing Company* v. *United States*, 446 F.2d 269 (10th Cir. 1971); Rev. Rul. 55-540, 1955-2 C.B. 39.

Factors in Rev. Rul. 55-540 which indicate a sale rather than a lease include:

1. The lessee acquires title after making a stated number of payments.
2. The lessee's payments for a short term of use are a large part of the payment necessary to secure a transfer of title.
3. Rent payments exceed fair rental value.
4. The lessee has a purchase option at a nominal price.
5. Some portion of the rental payments is identifiable as interest.

Tax consequences that may apply if a lease is determined to be a sale:

1. The lessor must report a gain or loss on the transaction.
2. The lessee cannot deduct rental payments.
3. The lessee is allowed to deduct depreciation and interest expenses on the property.
4. The lessee's basis in the property will be the sum of all payments made pursuant to the lease (excluding payments that represent interest or other charges).

A change from improperly treating property as leased by the taxpayer to treating such property as purchased by the taxpayer, or vice versa, is a change in method of accounting to which the provisions of IRC section 446 apply. Further, the provisions of IRC section 481 generally apply when such a change is made by the district director as part of an examination (that is, the taxpayer is not eligible to change its method under Rev. Proc. 97-27).

B. Automobile Expense

A veterinarian's trips between a residence and a hospital or the office are considered commuting, and the transportation expenses are personal, unless the residence qualifies as a home office for the veterinary business under IRC section 280A(c)(1)(A). Rev. Rul. 94-47, 1994-2 C.B. 18.

The type of adjustment for unallowable expenses depends on the taxpayer under examination.

1. If the taxpayer is an independent contractor claiming deductions for the taxpayer's own expenses, the unallowable expense is disallowed on Schedule C.
2. If the taxpayer is a partnership, a corporation, or an independent contractor, and the taxpayer provides an automobile to the veterinarian employee, the value of the personal use of the automobile is treated as employee compensation. See Treas. Reg. section 1.61-21.
3. If the taxpayer reimburses a veterinarian employee's automobile expenses, any unallowable expenses are treated as employee compensation. See Treas. Reg. section 1.62-2.

In addition, the leased auto income inclusion rules of Treas. Reg. section 1.280F-5T(e) applies to corporate and partnership owned vehicles.

C. Entertainment, Travel, and Meals

IRC section 274(d) provides explicit substantiation requirements for entertainment, travel, and meal expenses. However, even if the expenses are substantiated, they must be ordinary and necessary business expenses. Entertainment expenses must be clearly related to the production of business income. Criteria to be used in establishing the deductibility of entertainment expenses include, but are not limited to, the following:

1. Specific purpose of the entertainment.
2. Period of time the veterinarian has been in practice and the number of customers the veterinarian already has.
3. Percentage and number of customers received as referrals.
4. Names of individuals entertained and the reason additional income could reasonably be expected from each.
5. Number of times each individual was entertained during the year, because repeated entertainment may indicate a personal motive.
6. Whether other veterinarians in the locality have entertainment expenses (Special Ruling, June 12, 1958, 569 CCH p. 6575).

Note that no deduction is allowed for membership in clubs organized for business, pleasure, recreation, or other social purposes under IRC section 274(a)(3) for amounts paid after December 31, 1993. Also, IRC section 274(n) generally disallows 50 percent of otherwise deductible entertainment expense and food and beverage expenses.

Employer-provided membership in a country club or other social club, or an employer-provided ticket to an entertainment or sporting event, is employee compensation unless excludable under IRC section 132.

Constructive Dividends/Fringe Benefits

Constructive dividends can take many forms, such as excessive compensation, loans to shareholders, payments for the shareholder's benefit, shareholder use of corporate property, and bargain purchases. Some typical fringe benefits include automobile allowances or use of a corporate automobile, cellular phone or other communications equipment, tuition remittances, insurance, free or discounted membership in clubs, housing allowances, educational assistance, travel benefits, and free or below-market loans. In all cases, however, a dividend is not declared unless the transaction is deemed to be for the personal benefit of the shareholder rather than the corporation. Some

transactions commonly reclassified as a dividend are summarized below. Most adjustments for constructive dividends to veterinarians will occur in the payments for shareholder's benefit and the loans to shareholders categories.

A. Loans to Shareholders

One method of avoiding any type of taxable distribution to the shareholder is a loan from the corporation. If a distribution that was originally classified as a loan is in fact deemed not to be a bona fide loan, the amount will be considered a constructive dividend. See Chapter 3 for an in-depth discussion of this issue.

B. Payments for the Shareholder's Benefit

If the corporation pays the personal obligations of the veterinarian/shareholder, the payment may be treated as a constructive dividend based on the purpose of the expenditure. Some examples of constructive dividends that arise from a payment for the veterinarian/shareholder are personal debt, medical expenses, travel and entertainment expenses, personal use of a corporate automobile, and family members' wages when no bona fide services are performed. A corporation may allow the veterinarian/shareholder to receive money through the year and reclassify the payments from loan to wages at year end. If there is no agreement for the payment of bonuses in this manner, the distribution may be deemed a dividend.

C. Excessive Compensation/Rents/ Interest

When a corporation pays a veterinarian/shareholder compensation that is deemed excessive for the services provided, that portion considered unreasonable is treated as a constructive dividend. Similarly, excessive payments for the corporate use of shareholder property, for example, excessive rents and interest, may also give rise to a constructive dividend.

1. Determine the total compensation paid or accrued to the principal officers, taking into consideration any compensation claimed under heading other than officer's salaries, such as labor, contributions to pension plan for the officers, payments of personal expenses, and year-end or other bonuses.

2. Determine if and to what extent each principal officer's compensation is unreasonable by taking into account the following factors: nature of duties, background and experience, knowledge of the business, size of the business,

individual's contribution to profit making, time devoted, economic conditions in general, character and amount of responsibility, time of year compensation is determined, relationship of the stockholder/officer's compensation to stockholdings, whether alleged compensation is in reality, in whole or in part, payment for a business or assets acquired, and the amount paid by similar size businesses in the same area to equally qualified employees for similar services. Also, see the section on Inadequate Compensation in this chapter.

3. In closely held corporations, also determine that accruals payable to controlling stockholders are paid within the prescribed time limit.

D. Shareholder Use of Corporate Property

Constructive dividends can also occur when a veterinarian/ shareholder uses corporate property for personal purposes at no cost. The most common dividend in this category is the use of a company car. Of course, use of other company-owned property such as boats, airplanes, entertainment facilities, and vacation homes may also generate dividend treatment. The taxpayer may avoid dividend treatment by having the shareholder reimburse the corporation for any personal use of the property or by including the value of such benefits in the veterinarian/ shareholder's income as compensation.

E. Bargain Purchases

Corporations often allow shareholders to purchase corporate property at a price less than the property's fair market value. An example of this could be the purchase of animals or bulk feed. These so-called bargain purchases are treated as constructive dividends to the extent the fair market value of the property exceeds the amount paid for the property by the veterinarian/ shareholder or a family member.

F. Insurance Expense and Split Dollar Policies

The cost of a life insurance contract that is purchased under a qualified annuity, pension, or profit-sharing plan with deductible employer contributions, or with earnings of a trust created by such a plan is generally includable in the covered employees' gross income under Treas. Reg. section 1.72-16.

When examining the corporation, insurance expense can be a very straightforward deduction or can be found only by

examining interest payments deducted on the return. If any interest is attributable to a loan from an insurance company, further inquiries should be made concerning the transaction to determine if the interest payment is actually a disguised insurance premium payment. Such a disguised insurance premium typically takes the form of a "split dollar" policy purchased jointly by the corporation and the employee (usually a shareholder). The corporation borrows from the insurer, usually at the inception of the insurance coverage, and uses the loan proceeds to pay a large premium. "Interest" is then paid to the insurer; the employee has no obligation to reimburse the corporation for the interest payment, just for the premium payment. The economic substance of the transaction may be, however, that no "loan" exists and the deducted interest should be characterized as an insurance premium, nondeductible under IRC section 264(a)(1). See *Lowery R. Young, Jr., and Carolyn C. Young* v. *Commissioner*, T.C. Memo., 1995-379.

Under "split-dollar" insurance arrangements, the employer and employee join in purchasing an insurance contract on the employee's life, in which there is a substantial investment element. The employer pays that part of the annual premium which represents the increase in the cash surrender value each year, and the employee pays the balance of the annual premium.

The benefit to the employee is generally that the amounts paid as premiums by an employer or a corporation enable the insurance company to generate funds that then pay for the current cost of insurance coverage in later years, so that the portion of the annual premium paid by the insured shareholder decreases. The value of the benefit received is equal to the amount of the premium for the current insurance coverage that he or she is relieved from paying as a consequence of the payment made by the employer or corporation. This value is calculated by using either the Federal government's PS 58 rate table or term coverage rates published by the insurer. See Rev. Rul. 64-328, 1964-2 C.B. 11, as amplified by Rev. Rul. 66-110, 1966-1 C.B. 12.

The benefit to the employer or corporation is generally that the amounts paid as premium payments by the employer or the corporation are recovered out of the policy proceeds, thereby limiting the cost to the employer or the corporations to the loss of the interest on the amount advanced as premium payments.

Split-dollar life insurance policies are to be treated as conferring an economic benefit, taxable annually as compensation income. They are not to be treated as an interest-free loan from the employer to the insured employee. See *Arthur Genshaft and Leona Genshaft* v. *Commissioner*, 64 T.C. 282 (1975) and *Howard Johnson and Nobia F. Johnson* v. *Commissioner*, 74 T.C. 1316, 1322 (1980).

If you have additional questions concerning this issue, please contact the local or national COLI specialist.

Valuation of Fringe Benefits

If a fringe benefit is not specifically excluded or is only partially excludable from the employee's gross income by another Code section, then the benefit must be valued for inclusion in the employee's gross income.

A. General Rule - Fair Market Value (FMV)

The general rule of valuation is FMV. The regulations, however, provide special valuation rules for some commonly provided fringe benefits, such as the use of employer provided vehicles and airplanes. If an employer uses a special valuation rule, the special value is treated as the FMV of the benefit for all purposes -- income and employment tax.

B. Automobile Lease Valuation Rule

An employer may value an employee's personal use of an automobile by reference to the Annual Lease Value (ALV). The ALV is determined by the table provided in Treas. Reg. section 1.61-21(d)(2) according to the FMV of the vehicle as defined under Treas. Reg. section 1.61-21(d)(5) (includes sales tax). To determine the amount taxed to the employee first multiply the ALV by the business use percentage, which is the number of miles driven for the employer's business as a percentage of the employee's total annual mileage. The amount taxed to the employee is the difference between the ALV and the amount determined under the preceding sentence. The ALV includes insurance and maintenance but not fuel provided by the employer. Fuel provided in kind may be valued at 5.5 cents per mile for each mile the vehicle is driven in the United States. Where the cost of fuel is reimbursed by or charged to the employer, the value is based generally on the amount of the actual reimbursement per Treas. Reg. section 1.61-21(d)(3).

C. Cents-Per-Mile Valuation Rule

Under this valuation rule, an employer uses the standard mileage rate to value the number of miles driven by the employee for personal purposes (Treas. Reg. section 1.61-21(e)). This rule is available if the employer reasonably expects the vehicle will be "regularly used" (regular use requirement is met if at least 50 percent of the total annual mileage is for the employer's business) in the employer's business throughout the calendar year, or the vehicle is driven primarily by employees for at least 10,000 miles in a calendar year AND the FMV of the vehicle does not exceed $12,800, as indexed ($15,700 for automobiles first placed in service during 1997).

D. Commuting Valuation Rule

The commuting use of an employer-provided vehicle is valued at $1.50 per one-way commute if all of the following conditions are met:

1. The vehicle is owned/leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business and is used in the employer's trade or business;
2. The employer, for bona fide noncompensatory business reasons, required the employee to commute to and from work in the vehicle;
3. The employer has established a written policy under which the employee may not use the vehicle for personal purposes other than for commuting or *de minimis* personal use;
4. The employee, except for *de minimis* personal use, does not use the vehicle for any personal purpose other than commuting; and
5. The employee required to use the vehicle for commuting is not a "control employee" of the employer.

   A "control employee" is one who meets one of the following criteria:

   a. Is a board-appointed, shareholder-appointed, confirmed, or elected officer of the employer whose compensation equals or exceeds $50,000 as indexed ($72,500 for 1998);
   b. Is a director of the employer;
   c. Owns an 1 percent or greater equity, capital, or profit interest in the employer, or;

d. Receives annual compensation of more that $100,000 as indexed ($145,000 for 1998).

Employment Tax Implications of Fringe Benefits

If a fringe benefit is not excludable or only partially excludable from gross income, its value must be reported as wages in Box 1 of the employee's Form W-2 and the employer generally must withhold income taxes and the employee's share of FICA, in addition to paying its share of FICA and FUTA.

A. General Rule

B. Special Rule for Non-Cash Fringe Benefits

An employer may elect not to withhold income taxes on the value of the personal use of a vehicle, as long as the employer notifies the employee and includes the taxable amount on the employee's Form W-2. However, the value of the personal use of a vehicle is subject to social security taxes.

An employer may withhold income taxes at the flat 28 percent supplemental wage withholding rate.

An employer may treat non-cash fringe benefits provided in the last 2 months of the employer's tax year (for example, November and December) as paid during the following tax year. See IRS Announcement 85-113, 1985-31 I.R.B. 31.

Additional Tax Issues

A. Tax on Built-In Gains -- IRC section 1374

Virtually all medical PSCs have substantial amounts of accounts receivable. Since their tax returns are filed on the cash basis, the receivables are not realized for tax purposes until the payments are received. Under IRC section 1374, when medical C corporations elect S status after 1986, the built-in gains tax applies to the receivables that accrued when they were C corporations but were paid during the recognition period. The recognition period is 10 calendar years beginning on the first day on which the corporation is an S corporation or acquires C corporation assets in a carryover basis transaction.

Questions to consider:

1. Was it a C corporation prior to making its S corporation election?
2. Was the S corporation elec le after 1986?
3. Does it have a net recognized built-in gain within the recognition period?

4. Check to see that the net recognized built-in gain for the tax year does not exceed the net unrealized built-in gain minus the net recognized built-in gain for the prior years in the recognition period that were subject to tax.

The amount of tax imposed is computed by applying the highest rate of tax specified in IRC section 11(b) to the net recognized built-in gain of the S corporation for the taxable year. If there is a net operating loss from a C year, then the NOL carryforward will be allowed as a deduction against the net recognized built-in gain. If there is a credit carryforward under IRC section 39, the carryforward amount will be allowed as a credit against the tax.

Whipsaw Issue:

If you impose an IRC section 1374 tax on the corporation, you must also allow a corresponding deduction on the shareholder's personal return under IRC section 1366(f)(2).

B. Accumulated Earnings Tax -- IRC section 531

The basic aim of this tax is to prevent a corporation from accumulating income in order to shelter its stockholders from the individual income taxes that they would pay if the corporation's income were distributed to them as dividends. Therefore this tax is imposed on corporate earnings and profits that are accumulated in excess of reasonable business needs. Some accumulation is allowed without the risk of additional tax liability, but amounts in excess of $150,000 for service-type corporations should be examined to determine if the intent is a tax avoidance scheme of deferment of stockholder income.

To review this issue, it is generally helpful to effect a reconciliation of the surplus shown in the books to the earnings and profits available for tax purposes. Look for transfers to capital or other accounts in the form of stock dividends or reserves (which do not qualify as write-downs of earnings and profits), receipt of life insurance, or write-downs of purchased goodwill, or other intangible assets.

Retirement Plans

In response to tightened provisions relating to pension plan funding for highly compensated key employees, a funding vehicle has evolved which purports to be an employee welfare benefit plan. When analyzed, these plans are often highly funded plans designed to provide benefits primarily to the highly

compensated employees of closely-held corporations. These plans may be either non-qualified deferred compensation arrangements (in which case the employer's contribution would be deductible in accordance with IRC section 404(a)(5)), or welfare benefit plans (in which case the employer's contribution would be deductible in accordance with IRC sections 419 and 419A).

If the plan provides non-qualified deferred compensation, then the employer is allowed a deduction in the year in which the amount attributable to the contribution is includable in the gross income of the employees participating in the plan. (Note: depending on the specifics of the plan, an issue can be raised on the employee return that the amount attributable to the contribution is currently includable in the employee's income.) However, in the case of a plan in which more than one employee participates, the deduction under IRC section 404(a)(5) is allowed only if separate accounts are maintained for each employee.

If, instead, the plan is a welfare benefit fund, the employer's deduction each year is limited to the fund's "qualified cost" minus the "after-tax income" of the fund for that year. A welfare benefit is generally a benefit provided by an employer which provides for the welfare or general betterment of employees but which is neither a transfer of property nor deferred compensation.

Prior to the enactment of IRC sections 419 and 419A, Congress was concerned that welfare benefit plans were being utilized to defer compensation or otherwise accumulate, on a tax deferred basis, amounts for later distribution to highly compensated professional employees of closely-held corporations. These IRC sections were generally effective for tax years ending after December 31, 1985, and impose strict limits on the timing and amount of the deduction allowable to an employer for contributions to a welfare benefit fund. In general, and with certain exceptions, employer deductions are now limited to the amount of cash-basis benefits paid out of the fund. Additionally, the employer is allowed to prefund certain reserves for benefits to be paid by the fund in the future. The allowable reserves are for medical, disability, severance or SUB (supplemental unemployment compensation benefit) pay, and life insurance benefits. These reserves have strict dollar limits.

IRC section 419A(f)(6) provides an exception from the limits of IRC sections 419 and 419A for contributions to a plan to which ten or more employers contribute, if no one employer normally makes more than 10 percent of the total contributions to the plan and if the plan does not maintain "* * * experience-rating arrangements with respect to individual employers." The legislative history to this section explains that this exemption is provided because "* * * the relationship of a participating employer to [such a] plan is often similar to the relationship of an insured to an insurer," whereas the exemption is not available if:

> * * * [T]he liability of any employer who maintains the plan is determined on the basis of experience rating because the employer's interest with respect to such a plan is more similar to the relationship of an employer to a fund than an insured to an insurer.

A number of funds have been discovered that are designed to use the ten-or-more employer exception as a vehicle for funding large amounts of life insurance, disability, and severance pay benefits. Promoters have marketed these programs as an attractive alternative or supplement to qualified plans. The basic idea behind these arrangements is to establish a plan which is not subject to the deduction limitations imposed by either IRC section 404 or IRC section 419 and also avoid the current inclusion of income to the key employee under IRC section 402.

Most arrangements are funded through a trust which may be exempt under the provisions of IRC section 501(c)(9) (that is, Voluntary Employees' Beneficiary Associations (VEBAs)) or a taxable trust. Using a taxable trust usually means that benefits can be weighed heavily in favor of the owner or majority shareholder of the business since discrimination is not a factor, because (unlike VEBAs) taxable trusts are not subject to the nondiscrimination requirements of IRC section 505(b).

Employer contributions are generally invested entirely in life insurance contracts on the lives of covered employees. For those arrangements that provide benefits in addition to life insurance, the benefits are allegedly funded through the cash value of these policies. The arrangements also allow for a distribution of the policies and/or cash values to the employees when the employer terminates its participation in the plan. The so-called "death benefit only" arrangements generally purchase life insurance policies on key employees which possess features

which allow for the build-up of "credits" (as opposed to cash value) which, upon conversion from a trust-owned policy to an individually-owned policy, generate a significant cash value. This type of policy has traditionally been referred to as a "springing cash value" policy.

In response to the plans, the Service issued Notice 95-34. The purpose of this notice was to alert taxpayers and their representatives to the potentially significant tax problems raised by their participation in certain ten-or-more employer plans.

This issue was litigated in *Robert D. and Janice Booth* v. *Commissioner*, 108 T.C. 524 (1997), which involved the Prime Financial Welfare Benefit Plan and Trust. Although the Tax Court did not believe the plan was a plan of deferred compensation, the Court held that the plan did not qualify for the ten-or-more employer exception provided in IRC section 419A(f)(6) because it maintained experience-rating arrangements with respect to individual employers. As a result, the employers' deductions were limited under IRC section 419 to the qualified cost. In three of the four test cases, the qualified cost was zero. In the fourth test, the qualified cost was $11.

If you have any additional questions regarding this issue, contact the National 419/419A/VEBA issue specialist.

How to determine if this is an issue:

1. If Form 1120, line 25, contains a deduction for "employee benefits," request back up detail for this expense to see if it represents a contribution to a ten-or-more employer plan. Note that some taxpayers may have deducted this amount as an "insurance" expense. If this is the case, you will need to request back up detail for this expense. Note also that an additional issue may be present on the employees' returns relating to IRC section 61 and reporting the cost of receiving insurance protection (typically referred to as PS 58 costs).

2. During completion of Required Filing Checks, ask the taxpayer to provide all filed Forms 5500 or 5500-C/R, along with Schedule A. These forms contain a three-digit plan number. The number "501" represents a welfare benefit plan. Look to see if any of these involve the provision of life insurance, disability, and/or severance benefits.

employee's qualifications and tend to show reasonableness. See *Van's Chevrolet, Inc.* v. *Commissioner*, T.C. Memo., 1967-172, CCH 28,583(M).

During the interview phase of any examination, ensure that other officers and key personnel with overlapping and/or related responsibilities are also interviewed.

B. Nature, Extent, and Scope of Work

The amount of time devoted by an employee to his or her job is relevant in determining reasonable compensation, along with the character of the services provided.

Treas. Reg. section 31.3121(d)-1(b) provides that, generally, an officer of a corporation is an employee of that corporation if more than minor services are provided for remuneration.

Smaller salaries may be justified where the business success was not a result of the employee's expertise and managerial skills; however, in PSCs such as a veterinarian practice, this would be a difficult position for the taxpayer to put forth.

C. Employer's Salary Scale

In considering the employer's salary scale, the courts will likely compare the shareholder/employee's salary to the salaries of the other employees of the business. Trends in salaries may also be considered such as in *David Kipnis and Dorothy Kipnis* v. *Commissioner; Arizona Plating and Polishing Co.* v. *Commissioner*, T.C. Memo., 1982-471, CCH 39,271(M) and *Ken Miller Supply, Inc.* v. *Commissioner; Kenneth R. Miller and Lois N. Miller* v. *Commissioner*, T.C. Memo., 1978-228, CCH 35,224(M).

Where a significant disparity exists between the salaries of two or more employees who perform the same or similar duties, it will be difficult to establish that each employee's salary is reasonable.

D. Industry Compensation Rates

A valid method of determining the reasonableness of a shareholder's salary is to compare it with salaries of non-owner executives who have similar responsibilities in similar companies, during the same time period. The taxpayer often asserts that the company chosen for comparison is substantially

different, or is more/less successful, or in a more or less competitive market. Similarly, a taxpayer may assert that the comparative executive is represented to be more than a manager, for example, an inventor, key salesman, or founder of the company, etc.

Prevailing rates of compensation for comparable businesses furnish a guide, but not a rule. See *Estate of Walter S. Rae* v. *Commissioner*, T.C. Memo., 1943-988, CCH 13,159(M); *aff'd* 147 F.2d 204 (3d Cir. 1945). Perfect comparison is difficult, if not impossible. See *C. & C. Beverage, Inc.* v. *Commissioner*, T.C. Memo., 1954-95, CCH 20,454(M).

Look at the compensation of non-stockholder employees. For example, if a key employee is receiving much less than the shareholder/employees and has comparable responsibilities, there may be an issue as to the reasonableness of the shareholder/employees' compensation. See *Dahlem Construction Company* v. *United States*, 268 F.Supp. 103 (W.D. Ky. 1966).

Comparability studies for compensation issues may be found in the following sources:

1. Executive Compensation Series, prepared by Research Institute of America
2. Management Compensation Survey, prepared by Medical Group Management Association
3. Tax Management Report, prepared by American Management Association
4. Research of Labor Statistics

Remember a survey is only a guide and not an absolute standard. Comparability studies carry more weight if the companies being compared are in the same geographic region of the country.

See Exhibit 4-2 for the Veterinarian Industry Compensation rates.

E. Size and Complexity of the Business

The size of the business and complexity of operations may be considered in ascertaining the reasonableness of compensation paid to the shareholder/employee(s). Presumably, larger businesses engaging in more complex operations would be

required to pay larger salaries. Size may be established by reference to the amount of annual revenue, gross profit, operating expenses, and net income as well as reported assets and net worth. Complexity of operations may depend on a number of factors including, but not limited to, the amount of the business activities and the organizational structure.

F. Compensation-to-Income Ratio

In examining the ratio of compensation to business income, the courts appear to react to the trend of this ratio as much as the ratio itself. Further, courts may consider the direction of the compensation paid as compared to the income.

Compensation may be considered inadequate where the amounts paid over time are decreasing while taxable income shows an increasing trend. An increase or decrease in the compensation-to-income ratio should also be evaluated in light of any increases or decrease in services performed or responsibilities undertaken. See *B.B. Rider Corporation* v. *Commissioner*, 725 F.2d 945 (3rd Cir. 1984), and *Home Interior & Gifts, Inc.* v. *Commissioner*, 73 T.C. 1142 (1980).

G. General Economic Conditions

General economic conditions may be considered in ascertaining whether compensation is reasonable. When the shareholder/employee's responsibilities or the value of services has not changed, the courts may interpret any change in profits as due to the general economic conditions. In such instances, an increase in compensation received may be considered a distribution of profits. However, a downturn in economic conditions may be a defense where the taxpayer is attempting to justify a decrease in compensation as a cost-containment or survival tactic.

H. Prior Compensation and Compensation Compared to Dividends

The amount of compensation paid in prior years is a factor in determining the reasonableness of compensation. This is significant when the salary has been greatly increased or decreased without material change in company earnings. During a company's formative or lean years, executives sometimes are underpaid. Inquiry should be made as to evidence of corporate intent to compensate for past services. For example, prior creditor restrictions, poor cash balances, and actual profit and losses during the undercompensation period.

Take care in addressing this point if made by the taxpayer. Was

there a pre-existing written agreement or some written authorization by the Board of Directors to approve paying additional compensation to make up for underpaid years?

Greater evidentiary weight may be given to compensation determined early in the year as opposed to the year end, when profits can be determined. Bonuses which are voted at the end of the year, when profits are known, are suspect. Corporate minutes, whether formal or informal, should be considered along with other facts and circumstances surrounding the inadequate compensation issue.

The payment of or the failure of a company to pay dividends, standing alone, is not the sole support for finding of excessive compensation. Rather, the courts have considered the reason for the lack of dividends, for example, creditor restrictions, lack of earnings and profits, and the need for future expansion.

Prior compensation and distributions are also relevant with respect to inadequate compensation issues. A consistent policy of paying dividends or distributions coupled with a consistent absence of wages paid to shareholder/employees may indicate an intent to avoid payroll taxes.

Exhibit 4-3 contains an interview questionnaire which may assist examiners in analyzing the factors used in determining compensation. As always, this list is not all-inclusive and should be modified for the taxpayer under examination.

I. Case Histories

Since most veterinarian practices are single practitioners, the balance of the cases discussed will focus on sole shareholder corporations. Each of the following cases was decided in favor of increasing the compensation of the officer/shareholder because as the Ninth Circuit stated "* * * an employer should not be permitted to evade FICA and FUTA by characterizing compensation paid to its sole director and shareholder as dividends rather than wages." See *Spicer Accounting, Inc.* v. *United States*, 918 F.2d 90, 93 (9th Cir. 1990).

1. In *C.D. Ulrich, Ltd.* v. *United States*, 692 F. Supp. 1053 (D. Minn. 1988), the taxpayer, a CPA and sole shareholder, reported all monies received from the S corporation as distributions. As a result, he received no salary for the years cited. The taxpayer argued he was not an employee for employment tax purposes since he had no supervisors and set

his own work schedule. Because the taxpayer had provided more than minor services, however, the court deemed him to be an employee of the corporations subject to federal employment taxes.

2. In *Joseph Radtke, S.C.* v. *United States*, 712 F. Supp. 143 (E.D. Wis. 1989), *aff'd*, 895 F.2d 1196 (7th Cir. 1990), an S Corporation paid no salary to the taxpayer, an attorney and the corporation's only full time employee. The taxpayer was the sole incorporator, director, shareholder, and officer under an employment contract. He devoted all of his working time to providing legal services for the corporation's client. The court found that the taxpayer was the only significant employee of the corporation and that he provided substantial services. The court found that it was only logical that a corporation be required to pay employment taxes when it employs an individual, and stated that courts reviewing such cases were obligated to look at the substance, not the form, of the transactions at issue. The court declared that the "dividends" were in substance "wages" and that an employer should not be allowed to evade payroll taxes by characterizing all of an employee's remuneration as something other than "wages."

3. *Fred R. Esser, P.C.* v. *United States*, 750 F. Supp. 421 (D. Ariz. 1990) involved an S corporation formed by the taxpayer to perform legal services. He was the sole shareholder, the president, and the only attorney employed by the corporation. The taxpayer's wife was the sole clerical employee. Neither the taxpayer nor his wife was paid a salary, although the corporation "lent" the taxpayer money on almost a weekly basis. At the end of the year, the taxpayer would declare a dividend in an amount equal to the corporation's net taxable income. However, the taxpayer would leave the dividends in the corporation to pay back the "loans" he had received during the year. The district court held that the taxpayer was an employee due to his substantial legal services to the corporation, and therefore, the dividends distributed to him were treated as wages.

4. *Spicer Accounting, Inc.* v. *United States*, 918 F.2d 90 (9th Cir. 1990) involved an accounting firm controlled by the taxpayer, who was the president, treasurer, and director. In addition, the taxpayer and his wife were the only

shareholders of the S corporation. The taxpayer was never paid a salary by the corporation, but "donated" his services to the corporation and withdrew earnings in the form of dividends.

On appeal, the court noted that the taxpayer was the only accountant working for the corporation, performed substantial services on a continuing basis, and his services were integral to the operation of the firm. The court ruled that the "dividends" were in reality remuneration for employment and were therefore subject to FICA and FUTA. The court also rejected the taxpayer's contention that he was an independent contractor since the corporation provided him with supplies and a place to work and he performed accounting services for no other accounting firm.