

# Business Consultants Audit Techniques Guide

Revision Date - July, 2011

**NOTE:** This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

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# Objectives

Upon completion of this audit techniques guide, the examiner will be able to:

1. Identify and develop issues frequent and/or unique to the market segment.
2. Conduct an examination consistent with other market segment examinations throughout the Service.

## Other Required Material

You will need to obtain a copy of Publication 1976 (05/2007), *Independent Contractor or Employee?* IRS Catalog Number 22927M. The public can order this IRS Publication by calling (800) 829-3676.

# Market Segment Definition and Overview

## Introduction

Business consulting is one of the fastest growing industries in the world today. This trend is a result of many changes occurring in the world economy. During the past two decades, the business community has been downsizing which has caused displacement of many workers. These displaced workers have created a growing industry now known as "consulting." Some of these former employees are now contractors who are engaged by the same company and/or industry which previously employed them.

## Market Segment Definition

What is "consulting?" The dictionary defines consulting as being employed in giving professional advice, either to the public or to those practicing a profession. Treasury Regulation section 1.448-1T (e) (4) (iv) defines the field of consulting as "the provision of advice and counsel," but exclude sales and brokerage services, "or economically similar services." The distinction between the two is based on the facts and circumstances, but a significant factor is whether the taxpayer's compensation is contingent on the outcome of a particular transaction. Thus an economic analyst, data processing consultant, management consultant, or financial planner is performing "consulting" activities; while a securities broker, computer sales agent, recruiter, advertising agent, or insurance broker is not, although these activities may include some element of "advice and counsel."

Consulting in the practical sense can be anything. It is a common buzzword in the business world. Many people call themselves a consultant, when in reality they may be a broker, a salesperson, a retailer or engaged in a business which is a hybrid. One of the issues facing the industry is an influx of new entrants, many of them managers and executives who have been downsized. They open up shop independently or in collaboration with others. For many

displaced workers, consulting is something they say they are doing in the interim while searching for a job.

## **Common Practices**

Consultants commonly use a "rolodex" system and strategic alliances in order to fulfill their contracts. A "rolodex" system is a collection of companies and/or other individuals with different expertise that a person can refer to in order to obtain various services needed by their company. Normally, there is an informal agreement to make use of each other's services whenever possible. A strategic alliance is an affiliation with other companies whose expertise varies from their own. This is done with the intent of providing full service to a client. Each affiliate works as a member of a team to fulfill the requirements of a contract. (Thus, these alliances can provide one stop shopping for a client and act as a virtual company.)

## **Returns Examined**

This audit techniques guide is based on examinations of sole proprietors, corporations and partnerships completed by revenue agents. Background information was obtained from published books and periodicals.

## **Internal Control**

As part of every examination, the examiner needs to evaluate and document the internal control of the business. This is important in determining the agent's level of reliance on the taxpayer's books and records for the scope and depth of the examination. See [Exhibit C](#) for a sample questionnaire.

## **Conclusion**

This audit techniques guide is a tool to be used by examiners to assist in identifying frequent and unique issues associated with the business consulting industry.

This guide is set up to provide the examiner information on each potential issue that may arise in an audit within this industry. Each issue includes an introduction to the issue, pre-audit suggestions, audit techniques to assist in the issue and a law section describing the legal background for each issue.

## **Potential Issues**

### **Income**

#### **Introduction**

IRM section 4.10.4 outlines the minimum income probe requirements for all types of income tax returns. An examination of income is conducted to determine whether taxable income has been accurately reported on the tax return. IRM section 4.10.4 goes further to state that examinations of income for all business tax returns should incorporate industry-based audit techniques. Many consulting businesses are closely held and as a result internal controls may be inadequate. This provides an opportunity for inaccurately reporting of income.

## **Pre-Audit**

Every examiner will seek to determine that the taxpayer has reported all of the income required to be reported and that the income was reported in the proper period by the proper entity. The examiner should be alert for the following:

- The lack of internal controls (IRM 4.10.4.3.3.4 outlines examples),
- Be cognizant of the types of books and records the taxpayer maintains particularly in the area of electronic software,
- The taxpayer's use of bartering,
- The shifting or assignment of income by a taxpayer to a related entity,
- The taxpayer's use of the Internet. Examiners should use a search engine to check for an Internet Presence and ask the taxpayer about internet use,
- The taxpayer's use of a fiscal year end in order to defer income,
- Complete the Minimum Income Probe Lead Sheet including the section for e-commerce audit procedures,
- Where applicable request yK1 printouts,
- If consultant is a sole proprietor, secure Integrated Data Retrieval System (IDRS) income information.

## **Internal Controls**

Minimum income probes are required for individual and corporate business returns. The minimum income probes include an evaluation of internal controls. The examiner is instructed to determine the reliability of the books and records, regardless of the sophistication of the recordkeeping method. Refer to IRM 4.10.4.3.6.5 if the taxpayer maintains electronic books and records. IRM 4.10.4.3.3.4 identifies multiple examples of weak internal controls.

## **Electronic Software**

It has been estimated up to 75% of small medium sized businesses use electronic accounting software to maintain their books and records. Most accounting software programs can generate a large number of pre-set reports. Each report can be modified to fit the examiner's needs. When working with these reports within the accounting software program, the examiner can "drill down" to the underlying data and documents to further investigate items, as appropriate. In the majority of audits, examiners should request a copy of the taxpayer's original accounting software backup file as reviewing the electronic records should make the audit more efficient.

If you receive an electronic accounting software backup file from a taxpayer you should first check with your manager to determine if another examiner in your group has the appropriate software to read the backup file. If no one in your group has the appropriate software you should go to OS GetServices to open an ITAMS ticket. Click **My Technology**, click **Fix Existing Software**, select the category: **All Software Desktop/Laptop (COTS)**, and in the Description box, specify assistance is needed to convert an accounting software backup file, specify the brand of the accounting software that created the backup file, and list what edition (i.e., model) and version (i.e., year) of the software was used to create the backup. The ticket will be assigned to a person that has the appropriate software that can assist you. Caution ““ Do not include any sensitive but unclassified (SBU) taxpayer information in the ticket.

## **E-Business**

In every case, examiners should use a search engine to check for an Internet presence and ask the taxpayer about Internet use. Tips on effective Web searching can be located on the Internet by using the advanced search features of popular search engines to narrow results.

## **Audit Techniques**

IRM 4.10.4.3.6.1-3: provides techniques on identifying e-commerce business’, reviewing and saving Web sites, and interviewing the taxpayer. Interview questions should be tailored to the taxpayer and appropriate follow up questions asked.

## **Bartering**

The Internet has brought about resurgence in bartering exchanges. Bartering exchanges are required to file form 1099-B including payments to corporations with limited exceptions. A small proportion of this bartering activity is reported to the IRS.

In a slow economy, Taxpayer’s may encounter cash flow problems. Bartering for Internet service allows a Taxpayer to preserve precious cash for rent, utilities and salaries.

## **Law**

Section 61(a) provides, in part, that gross income means all income from whatever source, unless excluded by law. Section 1.61-1(a) of the Treasury Regulations provides, in part, gross income includes income realized in any form, whether in money, property, or services. Section 1.61-2(d)(1) of the regulations provides that, if services are paid for other than in money, the fair market value of the property or services taken in payment must be included in income as compensation.

Treasury Regulation 1.6041-1(g) states “*Payment made in medium other than cash.* If any payment required to be reported on Form 1099-MISC is made in property other than money, the *fair market value* of the property at the time of payment is the amount to be included on such form.”

One-on-one corporate bartering (the exchange of property and services) between corporations is not subject to information reporting requirement under IRC Sections 6041(a) or 6041A.

Barter transactions that are “facilitated” directly or indirectly by middlemen, organizations or individuals (that do not rise to the definition of “barter exchange broker” ) between corporations, individuals, or other entities are not subject to information reporting under IRC Sections 6041(a), 6041A, or 6045. (IRC Section 6045 relates to Form 1099-B.)

There is a significant probability that no Forms 1099-MISC were filed for bartering transactions. This is an area of high noncompliance.

## **Audit Techniques**

E-business has identified the following audit techniques for detecting bartering. Detecting bartering is a part of the income probe. The first step is to review the information that is readily available.

Does the Information Reporting Program (IRP) transcript indicate any Form 1099-B (Proceeds from Broker and Barter Exchange Transaction) for the tax year under examination?

If the taxpayer has a Web site, does the site indicate that the business is a member of a barter exchange or accepts bartering trades for services or goods? (Look for links, banners, and logos.)

During the tour of the business, is there an indication that the business is member of a barter exchange or accepts bartering trades for services or goods? For example, taxpayers often have signs, logos, or plaques regarding achievements, credit cards accepted, memberships, etc. Some of these may indicate barter organizations.

IRS has partnered with [Internet Reciprocal Trade Association \(IRTA\)](http://www.irta.com) and [National Association of Trade exchanges \(NATE\)](http://www.nate.org) to educate their members regarding bartering and taxes. The following Web sites provide useful information regarding how bartering works, its members, etc.

[www.irta.com](http://www.irta.com)

[www.barternews.com](http://www.barternews.com)

According to the IRTA Web site, “Last year IRTA Member Companies using the “Modern Trade and Barter” process, made it possible for over 400,000 companies to utilize their Excess Business Capacities and underperforming assets, to earn an estimated \$10 Billion dollars in previously lost and wasted revenues.”

Businesses that choose to participate in modern trade and barter will become a client of an IRTA Member Company. As clients when they sell their goods and services to other clients in the system they earn trade credits which are deposited into their accounts. They then have the ability

to purchase goods and services from other member clients utilizing trade credit in their accounts. See [Exhibit B](#) for interview questions.

During the course of the examination of the books and records be alert for fees paid to or invoices from a bartering exchange. If bartering was not detected, document the case file.

If bartering was found, the next step is to determine if the issue should be pursued in terms of compliance value and time to develop. Consider the dollar amount, volume and nature of the transaction(s). Remember to consider the basis of the item bartered (goods only).

On the other hand, if the taxpayer exchanged a single item, such as business asset for a personal item, such as two week time share at a vacation resort, it would be worthwhile to pursue. Exchange of services is another example of an issue that generally should be pursued. There is no basis and both income tax and self-employment tax may apply.

Once you have determined that the issue is worthwhile, it is suggested that you walk through one or two barter transactions with the taxpayer or representative. You need to determine if the transaction is properly reported as income, the expense is a legitimate business expense, and if so, that it was deducted only once.

Bartering requires the examiner to determine “*Fair Market Value*” (FMV). FMV represents the dollar value you will place on the income or cost portion of the barter transaction. This is not a new term that is singular to bartering transactions, but is a method of valuation that is of significance to many Internal Revenue Code sections and therefore there is a large body of regulations, rulings, and case law on the subject.

## **Shifting or the Assignment of Income / Substance versus Form**

Closely held or one-man personal services corporations, including business consultants, have assigned or shifted income earned by themselves, as individuals, or their closely held corporations, to another entity in order to reduce their income and or self-employment taxes. The taxpayer may shift income earned by one entity to a related entity in order to offset net operating losses of a related entity or in some cases to circumvent the Roth Individual Retirement Account limitations. Subsequent to this shifting of income, the taxpayer may take a relatively small salary from the entity (that received the assigned income) in relationship to the amount of income shifted.

## **Audit Techniques**

A review of the taxpayer’s consulting agreements/contracts should be conducted. The following are a list of items the examiner should search for in the agreement/contract:

- To whom is the client/customer contracting the services? Is the Taxpayer an S corporation or a partnership and yet the contract requires the services of a particular employee/owner?
- Is the contract voided upon the death of a particular employee of the Taxpayer?

- Do the terms of the agreement call for services that only one employee/owner is capable of performing?
- The examiner should trace the consulting fees per the contract to the Taxpayer's books and records.
- Request copies of all tax returns that are considered related returns of the taxpayer because the taxpayer has control. As outlined in IRM 4.10.4.3.4.3, the examiner should evaluate copies of tax returns of significant shareholders or partners (greater than 20% direct or indirect ownership) for:
  - a. examination potential (including issues unrelated to the corporate or partnership return),
  - b. the proper treatment of related transactions with the corporation or partnership, including losses from related parties, and
  - c. The likelihood of diverted funds.

See Exhibit 4.10.4-8., Tax Treatment of Diverted Income, if funds diverted from a corporation to a stockholder are identified.

## Law

The shifting of income or the assignment of income can be addressed by the examiner under the common law assignment of income issue under IRC 61 and/or the assignment of income under IRC 482. The courts have at times ruled that IRC 482 more readily applies than the common law assignment of income issue under IRC 61 (See *Fogelson v. Commissioner* 621 F.2d 865 (7<sup>th</sup> Circuit 1970).

A basic rule set forth by the Supreme Court provides that income is taxable to the one who earns it regardless of the fact that he may enter into a legally binding agreement to have it paid to another. (See *Lucas v. Earl*, 2 U.S.T.C. 496 (1930).

In *Worthley v. Commissioner*, T.C. Memo 1988-262, the court stated "The principle that income is taxed to the person who earns it is basic to our system of income taxation. *Commissioner v. Culbertson*, 337 U.S. 733, 739-740 (1949); *Lucas v. Earl*, 281 U.S. 111, 114-115 (1930). However, the court noted in *Johnson v. Commissioner*, 78 T.C. 882, 890 (1982), affd. without published opinion 734 F.2d 20 (9<sup>th</sup> Cir. 1984), cert. denied 469 U.S. 857 (1984), in cases involving closely held or one-man personal services corporations, a tension exists between the principle that income is taxed to the person who earns it and the principle that corporations are separate and distinct taxpayers from their owners. See *Moline Properties v. Commissioner*, 319 U.S. 436, 438-439 (1943).

In deciding whether an individual rather than his corporation is taxable with respect to income earned through his performance of personal services, the courts have held that the relevant inquiry is which of the two parties controls the earning of the income. *Johnson v. Commissioner*, 78 T.C. at 891. In this case, the court recognized that two elements **must be** present before a corporation, rather than its service-performer employee, may be considered the controller of income. These two elements are as follows:

1. First, the service-performer employee must be just that -- an employee of the corporation whom the corporation has the right to direct or control in some meaningful sense. The examiner should determine where the individual performing the service had a contract or employment agreement between himself and the corporation that would indicate the corporation had the right to control or direct the individual.
2. Second, there must exist between the corporation and the person or entity using the services a contract or similar indicium recognizing the corporation's controlling position. *Johnson v. Commissioner*, 78 T.C. at 891; citations omitted.”

The question under IRC 482 to be raised by the examiner is whether parties would have entered into their financial relationships had they been unrelated parties dealing at arms-length. See *Keller v. Commissioner*, 77 T.C. 1014, 1981, *Ach v. Commissioner*, 358 F.2d 342 (6<sup>th</sup> Circuit 1966), *aff'd* 42 T.C. 114 (1964), *cert. denied*, 385 U.S. 899 (1966); and sec. 1.482-1(b)(1), Income Tax Regs.

Although it has been held that a corporation is not required to pay a salary to an officer who performs services on its behalf (see *Gross v. Commissioner*, 23 T.C. 756, 773 (1955), *aff'd*. 236 F.2d 612 (2d Cir. 1956)), ***particular scrutiny is necessary when an individual incorporates an existing service profession and the corporation's only business activity is effected solely through the efforts of the individual as an employee of the corporation.*** A careful examination of the financial arrangements entered into will be required in order to ascertain whether an adjustment is necessary, either to clearly reflect income or to prevent tax avoidance.

## **Doctrine of Substance Over Form:**

How a transaction is taxed depends upon its substance. A transaction must be viewed as a whole, and each step from the beginning of negotiations to final consummation is relevant. The true nature of a transaction cannot be disguised by a mere outward appearance that exists solely to alter tax liabilities. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), 1945 C.B. 58.

In *Gregory v. Helvering*, 293 U.S. 465 (1935), a case that dealt with the issue of substance versus form, the Supreme Court of the United States stated, in part, that “the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.” When a step in a transaction is a mere “ritualistic incantation” in order to meet the words of the statute, that step will be ignored and the final result achieved will govern the tax consequences. *Ericsson Screw Machine Products Co.*, 14 T.C. 757 (1950).

In *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978), 1978-1 C.B. 46, 50, the Supreme Court summarized the principles underlying this doctrine:

This Court, almost 50 years ago, observed that “taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed” “the actual benefit for which the tax is paid.” *Corliss v. Bowers*, 281 U.S.376 (1930). In a number of cases, the Court has refused to permit the transfer of formal legal title to shift the incidence of taxation attributable to ownership of property where the transferor continues to retain significant control over the

property transferred. E.g., *Commissioner of Internal Revenue v. Sunnen*, 333 U.S. 591 (1948); *Helvering v. Clifford*, 309 U.S.331 (1940). In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded “the simple expedient of drawing up papers” , *Commissioner of Internal Revenue v. Tower*, 327 U.S.280, 291 (1946), as controlling for tax purposes where the objective economic realities are to the contrary. “In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding.” *Helvering v. Lazarus & Co.*, 308 U.S.252, 255 (1939).

In contrast, taxpayers are generally bound by the form in which they choose to cast their transactions. In *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 US 134, 94 SCt 2129, 5/28/74, rev’g CA-10, 472 F2d 796, the court stated:

This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, *Higgins v. Smith*, 308 U. S. 473, 477 (1940); *Old Mission Portland Cement Co. v. Helvering*, 293 U. S. 289, 293 (1934); *Gregory v. Helvering*, 293 U. S. 465, 469 (1935), and may not enjoy the benefit of some other route he might have chosen to follow but did not. ”To make the taxability of the transaction depend upon the determination whether there existed an alternative form which the statute did not tax would create burden and uncertainty.” *Founders General Corp. v. Hoey*, 300 U. S. 268, 275 (1937); *Television Industries, Inc. v. Commissioner*, 284 F. 2d 322, 325 (CA2 1960); *Interlochen Co. v. Commissioner*, 232 F. 2d 873, 877 (CA4 1956). See *Gray v. Powell*, 314 U. S. 402, 414 (1941).

In *Illinois Power Company v. Commissioner*, 87 T.C. 1417 (1987), *acq.* 1990-1 C.B. 1, the court noted that a taxpayer’s ability to make a substance over form argument is more limited than that of the Service. Specifically, the court indicated that a taxpayer can disavow the form of a transaction and assert its substance only if its “tax reporting and other actions show an honest and consistent respect for the substance of a transaction.”

*Id.* at 1430. In *Illinois Power Company*, the court permitted the taxpayer to assert that a transaction structured as a sale-leaseback was in fact a financing arrangement, but the court relied on facts showing that the taxpayer consistently had reported the transaction as a financing, both in financial reports and on its federal income tax returns. *Id.* at 1432-1433.

## **Codification of the Economic Substance Doctrine**

On March 30, 2010, H.R. 4872, Health Care and Education Reconciliation Act was signed into law. Title IV of the Act amended the Internal Revenue Code to codify the Economic Substance Doctrine and impose a strict liability penalty on any underpayment attributable to a noneconomic substance transaction. The amendments are generally effective for transactions entered into after

March 30, 2010. The provision would add section 7701(o) to the Code to provide that a transaction will only have economic substance if:

1. The transaction changes the taxpayer's economic position in a meaningful way (apart from federal income tax effects) and,
2. The taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.

## Research Materials

- Fogelson v. Commissioner 621 F.2d 865 (7<sup>th</sup> Circuit 1970)
- Lucas v. Earl, 2 U.S.T.C. 496 (1930)
- Worthley v. Commissioner, T.C. Memo 1988-262
- Commissioner v. Culbertson, 337 U.S. 733, 739-740 (1949)
- Lucas v. Earl, 281 U.S. 111, 114-115 (1930)
- Johnson v. Commissioner, 78 T.C. 882, 890 (1982), affd. without published opinion 734 F.2d 20 (9th Cir. 1984), cert. denied 469 U.S. 857 (1984) Moline Properties v. Commissioner, 319 U.S. 436, 438-439 (1943)
- Keller v. Commissioner, 77 T.C. 1014, 1981
- Pauline W. Ach, 358 F.2d 342 (6<sup>th</sup> Circuit 1966), aff'd 42 T.C. 114 (1964), cert. denied, 385 U.S. 899 (1966)
- Gross v. Commissioner, 23 T.C. 756, 773 (1955), affd. 236 F.2d 612 (2d Cir. 1956))
- Revenue Ruling 57-389
- Revenue Procedure 2002-38
- Notice 2010-62

## Uniform Issue Numbers

- 61.30-00 Assignments
- 61.30-03 Anticipatory Assignment of Income
- 61.39-00 Who is the Taxpayer?
- 61.43-00 Substance vs. Form
- 61.52-00 Bartering Income

## Tax Years

A Taxpayer may have improperly selected a fiscal tax year other than a calendar year end in order to defer income.

## Law

Code section 441 covers accounting periods. The Code has established special entity restrictions on tax years. Sole proprietorships must use the tax year of the individual owner (Revenue Ruling 57-389). A partnership must use the same tax year as its *partners*, unless a business purpose for using a different tax year is established (IRC 706(b) (1) and Treasury Regulation 1.706-1. A

corporation is generally permitted to choose from among a calendar year, a fiscal year, or a 52-53 week year. A personal service corporation must generally use a calendar year unless the corporation can establish to the satisfaction of the Secretary a business purpose for having a different period (IRC 441(i)).

In certain circumstances, a partnership, S corporation, or personal service corporation that cannot establish a business purpose for using a fiscal year maybe able to select a fiscal year if it makes the required election under IRC 444. A partnership, S corporation, electing S corporation, or PSC generally can elect under § 444 to use a taxable year other than its required taxable year, but only if the deferral period of the taxable year elected is not longer than the shorter of 3 months or the deferral period of the taxable year being changed. A partnership and an S corporation with a § 444 election must make required payments under § 7519 that approximate the amount of deferral benefit. Form 8752, Required Payment or Refund under IRC 7519, is used to calculate the payment due or the refund to be received. The payment or refund should be recorded as either an asset or a liability on the company's books. If it is not, the taxpayer may have reported the payment or refund as an expense or income. If that is the case, the examiner should look for an M-1 adjustment for the amount of the payment or refund. A PSC with a § 444 election is subject to the minimum distribution requirements of § 280H. A taxpayer may automatically adopt, change to, or retain a taxable year permitted under § 444 by filing a Form 8716, *Election to Have a Taxable Year Other Than a Required Taxable Year*.

If the taxpayer intends to choose a fiscal year, adequate books of account **must** be established before the end of the first accounting period.

Section 1.442-1(b)(2) provides that generally the requirement of a **business purpose** will be satisfied, and adjustments to neutralize any tax consequences will not be required, if the requested annual accounting period coincides with the taxpayer's required taxable year, ownership taxable year, or natural business year. Section 1.442-1(b)(2) also provides that, in the case of a partnership, S corporation, electing S corporation, or PSC, deferral of income to partners, shareholders, or employee-owners, will not be treated as a business purpose.

A taxpayer is deemed to have established **natural business year** through the use of a mechanical test if it satisfies the "25-percent gross receipts test." See Rev. Proc. 2006-46, 2006-2 C.B. 859. See Revenue Ruling 87-57 for examples of when an entity cannot satisfy the mechanical natural business year test has nonetheless established a business purpose for using a tax year other than a required year.

Section 1378 and § 1.1378-1(a) provide that the taxable year of an S corporation must be a permitted year. The term "permitted year" means (1) the required taxable year ( *i.e.*, a taxable year ending on December 31), (2) a taxable year elected under § 444, (3) a 52-53-week taxable year ending with reference to the required taxable year or a taxable year elected under § 444, or (4) any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Commissioner.

Section 441(i)(1) and § 1.441-3 provide that the taxable year of a PSC must be the calendar year unless the PSC makes an election under § 444, elects to use a 52-53-week taxable year that ends

with reference to the calendar year or a taxable year elected under § 444, or establishes, to the satisfaction of the Commissioner, a business purpose for having a different period for its taxable year.

A newly-formed partnership, S corporation, or PSC may adopt its required taxable year, a taxable year elected under § 444, or a 52-53-week taxable year ending with reference to its required taxable year or a taxable year elected under § 444 without the approval of the Commissioner pursuant to § 441. If, however, a partnership, S corporation, or PSC wants to adopt any other taxable year, it must establish a business purpose and obtain approval under § 442. *See* § 1.441-1(c).

Section 1.442-1(b) provides that in order to secure the approval of the Commissioner to adopt, change, or retain an annual accounting period, a taxpayer must file an application, generally on Form 1128, *Application to Adopt, Change, or Retain a Tax Year*, with the Commissioner.

## **Audit Techniques**

If the Taxpayer is a personal service corporation, partnership, S corporation or personal service corporation, determine if the Taxpayer established that it had a business purpose for having a tax period other than a required year end. See Revenue Procedure 2006-46 and Revenue Ruling 87-57.

If the Taxpayer did not establish a natural business year through the use of the mechanical test, and did not otherwise establish a business purpose for the use of a tax year other than the required tax year, determine if the Taxpayer filed an election under IRC 444 with Form 8716.

If the Taxpayer did make an IRC 444 election, determine if the Taxpayer make the required payments under IRC 7519. Review the books and records for asset or liability representing the payments calculated from Form 8752.

Request the Taxpayer's computation of its natural business year if the Taxpayer is relying on the mechanical test (Revenue Procedure 2006-46) to determine its fiscal year end.

Determine if the Taxpayer filed Form 1128 in order to secure the approval of the Commissioner to adopt, change, or retain an annual accounting period.

See IRM 4.10.3.5.3, Determination of Accounting Period.

## **Uniform Issue Numbers**

- 441.00-00 Period For Computation of Taxable Income
- 441.01-00 Definition of Taxable Year
- 441.02-00 Definition of Annual Accounting Period
- 441.03-00 Definition of Calendar
- 441.04-00 Definition of Fiscal Year

- 441.05-00 52-53 Week Year
- 441.06-00 Taxable Year of FSC's and DISC's
- 441.07-00 Taxable Year of Personal Service Corporations
- 441.07-01 Business Purpose
- 441.07-02 Definition of Personal Service Corporation (See also 269A.00-00, 448.00-00~ and 444.00-00)
- 441.08-00 Taxable Year of Partnerships (See also 706.00-00, 444.00-00)
- 441.09-00 Taxable Year of S Corporations (See also 1378.00-00, 444.00-00)

# Travel

## Introduction

There is extensive travel inside and outside the United States within the consulting field. This industry lends itself to significant travel because many consultants have a specialized niche and a broad geographical client base. Potential areas of concern:

1. Spousal/Family travel
2. Personal travel, particularly out of the United States

## Pre-Audit

When an examiner is performing a pre-audit analysis, he or she should expect to see a separate line item for travel. If no travel expense is reflected on the return, the examiner may want to follow-up to determine if travel expense may be incorrectly characterized on the return. The taxpayer may fail to allocate between the personal and business nature of the expense, as required under Internal Revenue Code section 274. The examiner will also need to prepare pertinent interview questions and request specific documentation on the Information Document Request. See [Exhibits D](#) and [E](#).

## Audit Techniques

A thorough interview is very important to find out where the taxpayer's client base is located and how often the taxpayer travels. The examiner should be alert to companion/family travel in and outside of the United States. The examiner can focus on extended travel beyond the actual business purpose and companion travel by testing the large, unusual or questionable items and sampling a time frame (i.e. 1 month).

## Law

To be deductible under IRC section 162(a) (2), an employee's traveling expense must be: (1) ordinary and necessary, (2) incurred in pursuit of a trade or business, and (3) incurred while away from home. *Commissioner v. Flowers, 326 U.S.465 (1946), 1946-1 C.B. 57.*

An employee's tax home is generally considered to be located at, or in the vicinity of, the employee's regular (or principal if more than one regular) place of business; while performing services there, an employee may not deduct the cost of meals and lodging, even if the employee maintains a permanent residence elsewhere. Rev. Rul. 93-86, 1993-2 C.B. 71; Rev. Rul. 75-432, 1975-2 C.B. 60; Rev. Rul. 60-189, 1960-1 C.B. 60.

If the employee has no regular or principal place of business, the employee's tax home is the employee's "abode in a real and substantial sense." If the employee has neither a regular or principal place of business, nor an abode in a real and substantial sense, the employee is an itinerant and effectively is never away from home. Rev. Rul. 73-529, 1973-2 C.B. 37; Rev. Rul. 71-247, 1971-1 C.B. 54; Rev. Rul. 60-189.

If the employee has two or more regular places of business, the tax home is located at the principal place of business. Rev. Rul. 93-86; Rev. Rul. 75-432; *Markey v. Commissioner*, 490 F.2d 1249 (6th Cir. 1974). Thus, expenses of travel incurred while discharging duties at a location that is removed from the principal post of duty (i.e., incurred at the non-principal place of business) are deductible if the other requirements of IRC section 162(a)(2) are met. The location of an employee's principal place of business is a question of fact; important factors include: total time ordinarily spent at each of the business posts, the degree of business activity at each post, and whether the financial return with respect to each post is significant or insignificant. Rev. Rul. 54-147, 1954-1 C.B. 51.

The employee is treated as being "away from home" during any period of employment at a single location only if the employment is temporary. Rev. Rul. 93-86. For this purpose, employment that is realistically expected to last for 1 year or less, based on an objective determination at the time employment is begun, is treated as temporary (in the absence of facts or circumstances indicating otherwise). However, an indefinite or regular work location does not necessarily become temporary because of brief and infrequent work assignments to other locations. *Blatnick v. Commissioner*, 56 T.C. 1344 (1971). Finally, an employee is not "away from home" unless the employee is at the assigned work location long enough to require an overnight stay. *United States v. Correll*, 389 U.S. 299 (1967), 1968-1 C.B. 64.

IRC section 274(d) provides that no deduction shall be allowed under IRC sections 162 or 212 for any expenditure away from home unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his or her own statement the amount, time, place and business purpose of the expenditure. IRC section 274 and Treas. Reg. sections 1.274-5T(c) (1) and 1.274-5A(c) (1) require that the elements of any expenditure must be recorded "at or near the time" when the expense was incurred. Although not required, these sections contemplate that the taxpayer will maintain a diary, travel log, trip sheet, or similar documentation while the taxpayer has current knowledge of the travel expenditure. The taxpayer may rely on "other sufficient evidence", but that evidence must be as specific and detailed as to the elements of the expense as the "adequate records provision."

IRC section 274(c) provides rules for the substantiation of foreign travel. For travel outside the United States that is entirely in pursuit of a trade or business, the entire amount of expenses incurred are deductible. However, if a portion of travel is for nonbusiness activities, the taxpayer

must allocate her/his travel expenses between personal nondeductible costs and deductible business expenses. No such allocation is required if less than 25 percent of the time spent outside the United States was for nonbusiness activities of the taxpayer.

IRC section 274(m)(3), effective for taxable years after 1993, disallows the deduction of travel expenses incurred with respect to a spouse, dependent, or other individual accompanying the taxpayer unless that individual is an employee of the taxpayer who is traveling for a bona fide business purpose, whose expenses would otherwise be deductible.

Note well that there are also special rules in IRC section 274(m)(1)(A) for luxury water transportation and under IRC section 274(h) for conventions or seminars held outside of North America or on a cruise ship.

## Research Materials

Below list is not designed to be all-inclusive.

- *Charron v United States*, 97-2 USTC ¶ 50,852
- *Pasharikoff v Commissioner*, TCM 1997-208
- Revenue Ruling 79-425, 1979-2 CB 81
- Revenue Ruling 75-169, 1975-1 CB 59
- *Commissioner v. Flowers*, 326 U.S.465 (1946), 1946-1 C.B. 57
- Rev. Rul. 93-86, 1993-2 C.B. 71
- Rev. Rul. 75-432, 1975-2 C.B. 60
- Rev. Rul. 60-189, 1960-1 C.B. 60
- Rev. Rul. 73-529, 1973-2 C.B. 37
- Rev. Rul. 71-247, 1971-1 C.B. 54
- *Markey v. Commissioner*, 490 F.2d 1249 (6th Cir. 1974)
- Rev. Rul. 54-147, 1954-1 C.B. 51
- *Blatnick v. Commissioner*, 56 T.C. 1344 (1971)
- *United States v. Correll*, 389 U.S. 299 (1967), 1968-1 C.B. 64

## Uniform Issue Numbers

- 274-03-00 - Traveling
- 274-08-00 - Substantiation
- 274-09-00 - Foreign Conventions
- 274-10-01 - In general
- 274-13-03 - Luxury Water Transportation
- 274-13-04 - Spousal Travel

# Independent Contractor vs. Employee

## Introduction

The independent contractor versus employee issue is prevalent in many industries. The consulting industry is no exception.

Potential areas of concern are:

1. A former employee coming back to a company as an independent consultant with a minimal break in service.
2. The continued use of the same strategic alliances.

The first potential issue has evolved due to the downsizing taking place in the business world over the past decade. Many employers, in an effort to lower costs, have terminated specialized employees and then hired them back as independent consultants. This allows the employer to lower their costs in payroll and employee benefits.

The second potential issue may arise when a consultant obtains a client for which they do not have all the resources themselves to fulfill the contract. To meet the needs of their client they form business relationships [strategic alliances or use of a "card catalog system"(see glossary of terms)] with other individuals. This can lead to an employee/employer relationship.

## **Pre-Audit**

First area of concern - During the pre-audit phase, this issue may not be apparent from the face of the return. If the return being examined is an individual return, the examiner will want to obtain IRPTRO from IDRS to determine the source of the gross receipts from consulting. The examiner will also want to prepare interview questions to address this potential area. See [Exhibit E](#).

Second area of concern - When the examiner is reviewing the return during the pre-audit phase of the examination, the examiner needs to be alert to large consulting or contract expenses, or expenses for other services. If the individual incurs significant unreimbursed expenses, this would be a factor in determining an employer/employee relationship. The examiner will want to prepare interview questions. See [Exhibit E](#).

## **Audit Techniques**

When the examiner decides to pursue this issue, the first step is to determine if the individual has a safe haven as an employer under Section 530. The examiner must supply the individual with publication 1976 to assist him/her in this determination. See [Exhibit D](#). See [Exhibit E](#) for a questionnaire/workpaper to aid the examiner in reaching a conclusion, as to whether, the individual meets the requirements for treatment under Section 530. If the individual does not qualify for the Section 530 relief, the examiner may go forward with the development of this issue.

First area of concern: This issue is a facts and circumstances issue. The examiner will need to analyze the individual's answers to the interview, as well as the contract (written or oral)

between the individual and his or her major client to see if an employee/employer relationship exists. The examiner will want to be alert to behavioral control, financial control and the relationship of the parties. See [Exhibit D](#) for more details.

Second area of concern: This issue is also a facts and circumstances issue which the examiner will want to develop based upon behavioral control, financial control and the relationship of the parties. See [Exhibit D](#) for additional details.

## Law

Section 530 of the Revenue Act of 1978, provides relief for individuals involved in controversies over their employment status with the Internal Revenue Service. Section 530 is not part of the Internal Revenue Code, but may be found in Public Law 95-600 of the Revenue Act of 1978, 1978-3 C.B. 119.

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. (IRC section 530 deals with education individual retirement accounts.) Section 530 has been amended by subsequent legislation, specifically; section 1706 of the Tax Reform Act of 1986, Pub. L. No. 99-514, 1986-3 C.B. (Vol. 1) 1, 698, and section 1122 of the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 1996-3 C.B. 155, 166.

Section 530 should be addressed as early as practical where the employment status of a consultant is at issue exists. Discuss with the individual the reasons why he or she believes they were treated as either an independent contractor or as an employee. Failure to correct an individual's improper treatment of their "employee" during an examination provides the taxpayer a "safe haven." Thus, it is important to correct employee status.

Section 530(a)(1) terminates an employer's liability for employment taxes under subtitle C, which includes FICA, FUTA, and income tax withholding, and 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 independent contractor.

To qualify for relief under Section 530, an individual must meet three general requirements:

1. Required Forms Filed - All Federal tax returns required to be filed by the individual, with regards to the treatment of individuals as independent contractors, must be filed timely.
2. Consistent Treatment ""
  - a. The treatment of an individual as an independent contractor must be consistent with the treatment by the employer of any individual holding a substantially similar position
  - b. A substantially similar position exists when the job functions, duties, responsibilities, the party controlling functions, and the exercise of the duties and responsibilities are substantially similar.

3. Reasonable Basis - Reasonable basis is established under Section 530(a)(2) if the individual can show reasonable reliance on one of the following:
  - a. Judicial precedent, published ruling, technical advice with respect to the individual, or a ruling issued to the individual
  - b. Reliance on a past Internal Revenue Service audit, if that audit entailed no assessment attributable to the individual's treatment of those holding positions substantially similar to that held by the individual whose treatment is at issue.
  - c. Reliance on a private letter ruling issued to the taxpayer to establish a reasonable basis under Section 530(a)(2).
  - d. A long-standing, recognized practice of a significant segment of the industry based on the geographical location in which the individual does business. 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.

The determination of whether a consultant is an employee or independent contractor is a factual question to be determined upon the consideration of the facts and the circumstances and the application of the law and regulations to 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 a consultant's status are found in three substantially similar sections of the Employment Tax Regulations; namely, sections 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1, relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Federal income tax withholding, respectively.

In general, it should be noted that IRC section 3121(d)(2) 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, the most important question is the amount of control the person or entity has over the individual hired to perform the services. This control question has been broken down into three areas of inquiry: 1) behavioral control; 2) financial control; and 3) relationship of the parties. Within these areas of inquiry, there are certain factors which indicate the level of control over the individual employed. These factors are set forth in [Exhibit E](#).

These factors have been developed based on the 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 factual context in which the services are performed. See Rev. Rul. 87-41, 1987-1 C.B. 296. These factors are not to be applied mechanically as a scorecard, but are to be used as an aid in applying the common law rules. Having determined the relevant factors, consideration must be given to the relative weight of these factors in determining the consultant's status. The auditor will then need to weigh the facts and circumstances of each case and determine a consultant's status accordingly. Determination of employee vs. independent contractor status is relevant with respect to the following federal tax issues: (1) whether an

individual is liable for the employee's share of the FICA tax; (2) whether business expenses must be itemized and are subject to the 2 percent floor on miscellaneous itemized deductions of IRC section 67 or are subject to the adjusted gross income additions of IRC section 62(c) and the itemized deduction limitation of IRC section 68; (3) whether the firm's qualified pension plan must treat the individual as an employee for qualification purposes; and (4) whether the individual has a right to continuing health care coverage after termination for purposes of Consolidated Omnibus Reconciliation Act of 1986, P.L. 99-272 (COBRA). In addition, employee status is also relevant for purposes of determining coverage under or liability for workers' compensation benefits, federal and state civil rights laws, the Fair Labor Standards Act (regulating minimum wage and overtime pay), the national Labor Relations Act (providing employees with the right of collective bargaining), the Occupational Safety and Health Act (regulating safety in the workplace), and the Americans with Disabilities Act (requiring employers to make special accommodations for disabled employees).

For further assistance regarding employment tax issues, contact the employment tax coordinator. For further assistance regarding Section 530 issues, contact the Area Counsel offices or Employment Tax Branch 1 of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities).

## **Other Information**

The examiner should inquire about any Classification Settlement Programs available to the individual. See Chapter 6, Classification Settlement Program (CSP) of IRM 4.23, *Employment Tax Handbook*, for more information.

## **Research Materials**

Below list is not designed to be all-inclusive.

- Misc-Doc: Training Guide - Worker Classification
- Audit Technique Guide for Trucking Industry - Chapter 5
- *Ren-Lyn Corporation v United States*, 97-1 USTC 50,385 [968 F.Supp 363(N.D. Ohio 1997]
- *La Nails Inc. v United States*, 98-1 USTC 50,438
- Rev. Rul. 87-41, 1987-1 CB 296

## **Uniform Issue Numbers**

- 3121-05-00 Employer vs. not Employer
- 3121-04-01 Employee vs. non Employee

## **Meals and Entertainment**

## Introduction

Given the considerable travel usually required in this industry, there may be a sizeable expense for meals/entertainment. Potential areas of concern:

1. Personal (i.e.: lack of business purpose)
2. Is the applicable percentage limitation being applied properly (currently 50 percent limitation)
3. Travel status meals/entertainment should be limited if not being reimbursed by client. (See reimbursed expenses)
4. Meals/entertainment in non-travel status

## Pre-Audit

The examiner may want to pay particular attention to the limitation of meals and entertainment while in travel status (because many taxpayers are unaware that the limitation applies to meals while in travel status). If no meals/entertainment expense is reflected on the return, the examiner may want to follow-up to determine if the expense may be incorrectly categorized on the return. The taxpayer may have failed to apply the appropriate percentage limitation. During the pre-audit analysis, the examiner will want to prepare pertinent interview questions and request specific documentation on the Information Document Request. See [Exhibits A, B and C](#).

## Audit Techniques

Sample to verify that the taxpayer is complying with IRC section 274. When the examiner reviews the sample, he or she should inspect for substantiation purposes, and verify that the taxpayer has properly applied the limitation to all unreimbursed meals and entertainment.

## Law

To deduct meal and entertainment expenses, the taxpayer must establish that the expense was one that was "ordinary and necessary" in carrying on his trade or business. IRC sections 162(a) or 212. The taxpayer must also show that the expense was either "directly related to" or "associated with" the active conduct of such trade or business. IRC section 274(a)(1)(A) and Treas. Reg. section 1.274-2(a).

IRC section 274(d) provides that no deduction shall be allowed under IRC section 162 or 212 for meal or entertainment expenses unless the taxpayer substantiates these expenses by adequate records or by sufficient evidence corroborating his or her own statement. To deduct such expenses, the taxpayer must record: 1) the amount of the expense and a description of each separate expenditure; 2) the time and place the entertainment or meal was provided; 3) the business purpose of the activity, including a description of any business benefit derived or expected; 4) the nature of the business discussion; and 5) the business relationship to the person or persons entertained.

IRC section 274 and Treas. Reg. sections 1.274-5T(c)(1) and 1.274-5A(c)(1) require that the elements of any expenditure be recorded "at or near the time" when the expense was incurred. Although not required, these sections contemplate that the taxpayer will maintain a diary, travel log, or similar documentation while the taxpayer has current knowledge of the travel expenditure. The taxpayer may rely on "other sufficient evidence," but that evidence must be as specific and detailed as to the elements of the expense as the "adequate records" provision.

Under Rev. Proc. 2000-9 I.R.B. 280, expenses of traveling away from home may be deemed substantiated. The amount of meal expense deemed substantiated by employees, who are reimbursed by their employers (or another payor) is the lesser of the payor's allowance for meals for the day or the amount computed at the M&IE rate for the locality for such day. Section 4.02. The amount that may be deducted on an employee's or self-employed individual's income tax return (after including any reimbursement received) is the amount computed at the M&IE rate for the locality of travel for the day of travel. Sections 4.03 and 7. There is a special provision for taxpayers working in the transportation industry (including truckers). Section 4.04.

IRC section 274(n) generally requires that the amount of an otherwise allowable deduction for the cost of business entertainment and meals be reduced by a flat 50 percent, unless these expenses are being reimbursed by a client.

## Research Materials

- Below list is not designed to be all-inclusive.
- *Commissioner v Heininger*, 320 U.S. 467 (1943).
- *Charron v United States*, 80 AFTR2d 97-6948.
- Revenue Ruling 63-144, 1963-2 CB 129

## Uniform Issue Numbers

- 274-01-00 Entertainment, amusement or recreation
- 274-03-00 Traveling
- 274-08-00 Substantiation
- 274-12-00 Business Meals
- 274-13-01 Entertainment
- 274-14-00 Applicable Percentage Limitation

# Personal Service Corporation

## Introduction

Consulting is a qualifying field within the meaning of personal service corporations. Many businesses that describe their services as consulting may not necessarily meet the definition of consulting outlined in the Treasury Regulations. The definition under Treasury Regulation section 1.448-1T(e)(4)(IV) states that the performance of services in the field of consulting

means the provision of advice and counsel. This does not include services such as sales or brokerage services, or economically similar services.

## **Significant area of concern:**

Does a C corporation meet the definition of a qualifying personal service corporation? Reasons for concern:

1. Some C corporations may want to be considered a personal service corporation in order to be able to use the cash method of accounting.
2. Some C corporations may not want to be considered a personal service corporation in order to take advantage of the graduated tax rates.

## **Pre-Audit**

Examiners need to be aware that, as stated in the overview, consultants can be anything. Many businesses use the word consulting to describe their services when, in fact, they are not only providing advice and counsel, but are also providing other services. This potential issue is driven by the facts and circumstances. As a result, a thorough interview is vital. See [Exhibit B](#) and [C](#). See also [Exhibit D](#) for sample Information Document Request.

## **Audit Techniques**

Review the stock record book to verify stock ownership. Review contracts to verify the facts and circumstances which have been obtained in the interview. If a determination is made that the taxpayer is a personal service corporation other issues to consider may include:

- Passive Activity Rules (There is an audit techniques guide available.)
- Taxable Year (generally a calendar year)
- Employee-Owner compensation deduction limitation (if an election has been made to use a taxable year, other than a calendar year).
- Personal Service Corporation formed to avoid or evade income tax.

## **Law**

### **Accounting Method**

IRC section 448 denies certain entities the use of the cash method of accounting. A "qualified personal service corporation" is an exception to the rule of IRC section 448. To qualify as a qualified personal service corporation, the corporation must meet a "function test" and an "ownership test." The "function test" requires that 95 percent of the entity's activities involve the performance of services in one of the areas listed in Treas. Reg. section 1.448-1T(e)(4)(i). Consulting is one of the areas listed in this regulation. Treas. Reg. section 1.448-1T(e)(4)(iv) defines "services performed in the field of consulting" as the provision of advice and counsel and

excludes performance of sales or brokerage services, or economically similar services. In determining whether the services performed fit within this definition, this section advises that you must look to all the facts and circumstances, which include the manner in which the taxpayer is compensated for the service provided. The regulation provides examples to illustrate the distinction between consulting and sales or brokerage services.

The "ownership test" requires that 95 percent of the entity's stock be owned directly or indirectly by active or retired employees engaged in providing such services, their estates, or any other person acquiring the stock by reason of their death. Indirect ownership may be held through a partnership, S-Corporation, another personal service corporation, or a grantor trust and community property laws are disregarded. No other attribution rules apply. Treas. Reg. section 1.448-1T(e)(5)(iii) and (iv).

## **Tax Rates**

IRC section 11(b)(2) does not allow personal service corporations the advantage of using the graduated tax rates. There is a set percentage applied to the taxable income. See Code for applicable personal service corporation.

## **Passive Losses**

The passive activity loss limitations of IRC section 469 apply to personal service corporations to insure that passive losses may not be offset against active income. IRC section 469(a)(2). This section adopts the definition of "personal service corporation" set forth in IRC section 269A, with certain modifications. IRC section 469(j)(2)(A) substitutes "any" ownership of stock for the 10 percent requirement in the definition of "employee-owner." The performance of any services for a corporation renders the person an employee for this purpose, even if that person would be considered an independent contractor for other purposes. Treas. Reg. section 1.441-4T(h)(1). The attribution rules of IRC section 318 generally apply in determining ownership in the personal service corporation, again modified so that "any" stock interest in a corporation who has "any" interest in the personal service corporation will cause the employee to be considered an "owner" in that corporation.

To determine whether the corporation is a personal service corporation, you must determine whether any "employee-owners" owned more than 10 percent of the stock, by value of the corporation on the last day of the testing period, which is generally the preceding taxable year. You must also determine if the performance of personal services was the principal activity during the testing period. This determination depends on whether more than 50 percent of the corporation's compensation costs during the testing period were attributable to personal service activities. Treas. Reg. section 1.441-4T(f). The final determination is whether the personal services provided by the personal service corporation are "substantially" performed by employee-owners. This determination is made by determining if more than 20 percent of the corporation's compensation costs were attributable to services performed by employee-owners. Treas. Reg. section 1.441-4T(g)(1). If all these criteria are met, the corporation is a personal service corporation and is subject to the passive loss limitations.

## Taxable Year

In general, for a personal service corporation, the calendar year is required for the taxable year for all taxable years beginning after 1986. IRC section 441(i). The definition of what constitutes a personal service corporation is the same analysis as discussed above to determine the application of the passive loss limitations under IRC section 469.

## Employee-Owner Compensation Deduction Limitation

IRC section 280H limits the deduction allowed for amounts paid by a personal service corporation to employee-owners. This section is only applicable if the corporation has made an election under IRC section 444 to use a taxable year other than the required taxable for a personal service corporation and has failed to meet minimum distribution requirements for the taxable year.

## Tax Avoidance by Personal Service Corporations

Under IRC section 269A, the Service has the power to allocate income, deductions, credits, exclusions and other allowances between a personal service corporation and its employee-owners. Three conditions must be satisfied before reallocation may be made under this section. These requirements are: 1) substantially all of the services of a personal service corporation are performed for or on behalf of one other corporation, partnership, or other entity; 2) the principal purpose of using the personal service corporation is the avoidance or evasion of Federal income tax by reducing income or increasing deductions that would not otherwise be available; and 3) the allocation is necessary to prevent the avoidance or evasion of Federal income tax or clearly reflect the income of the personal service corporation or any of its employee-owners.

Under this section, "personal service corporation" means a corporation the principal activity of which is the performance of personal services and such services are substantially performed by employee-owners. Generally, "employee/owners" is any employee of the corporation who on any day during the taxable year owns more than 10 percent of the outstanding stock of the corporation. For purposes of determining "employee-owners," the constructive stock ownership rules of IRC section 318 apply, with certain modifications.

**Note:** that safe harbor protection is provided for certain personal service corporations under Proposed Treas. Reg. section 1.269A-1(c). Generally, a personal service corporation will be deemed not to have been formed or availed of for the principal purpose of avoiding or evading Federal income taxes if the reduction in Federal income tax liability of each employee-owner does not exceed certain amounts.

## Uniform Issue Number

- Exception to graduated tax rates
- 269A-02-01 Personal Service Corporations

- 269A-02-02 Employee-Owner
- 280H-00-00 Limitations on certain amounts paid to employee-owner by personal service corporations electing alternative taxable year
- 441-07-00 Taxable year personal service corporation
- Election of taxable year other than required year
- Taxpayer qualified to make election
- Cash Limitation
- 448.04-00 Qualified personal service corporation exception
- 448.04-01 Function test
- 448.04-02 Ownership test
- Disallowed loss and credit (passive activities)

# Activities Not Engaged in For Profit, IRC § 183

## Introduction

Examiners should consider the activities not engaged in for profit issue when examining business consultants. This is an area which can easily lend itself to abuse. The use of the word "consultant" in a business title provides an air of legitimacy to the business purpose. The taxpayer may be deducting expenses while having little or no revenue. The IRC § 183 activities not engaged in for profit rules applies to (1) individuals; (2) S corporations; (3) partnerships; (4) and trusts and estates. IRC § 183 does not apply to C corporations.

## Pre-Audit

It is not always easy to determine from looking at the return if an activity is not engaged in for profit. Examiners should be alert to see if there is a "reasonable" indication that there is a "likelihood" of an activity not engaged in for profit in the pre-audit stage of the examination. The amount of pre-plan time spent will vary with the complexity of the case.

Examiners should consider the following in their pre-audit analysis:

- Are there activities with large expenses and little or no income?
- Are losses offsetting other income on the return?
- Does the activity result in a large tax benefit to the taxpayer?
- Does the history of the activity show that it is generating any profit in any years?

If the examiner suspects that the Taxpayer may be involved in an activity not engaged in for a profit, it is recommended that examiners review the IRC § 183, Activities Not Engaged in For Profit Audit Technique Guide.

## Research Materials

# Reimbursed Expenses

## Introduction

Reimbursed expenses are expenses which the taxpayer will recoup directly from their client. These are very common in the consulting industry. They can include travel, meals, products and advertising, among others. Examiners may find one or more of the following scenarios in the taxpayer's accounting system:

- The taxpayer will reflect the reimbursed funds as income and then take a corresponding deduction.
- The taxpayer will net the income and the associated expense through one account.
- The taxpayer will not record the income but will deduct the related expense.
- Reimbursements provided under non-accountable plans are taxable wages subject to employment taxes. Reimbursements provided under accountable plans that are in excess of substantiated expenses are taxable wages subject to employment taxes if excess is not returned within a reasonable period of time. See section 62 of the Internal Revenue Code.

Based on these scenarios, the examiner will want to be alert to the tax effect of reimbursed expenses given the taxpayer's method of accounting. Since reimbursed expenses are very common in this industry, the examiner needs to determine who is responsible for the 50 percent limitation on business meals and entertainment. If the taxpayer is not being reimbursed the limitation applies to the taxpayer.

## Pre-Audit

Reimbursed expenses may be reflected on the tax return in various ways. Some taxpayers differentiate reimbursed expenses as a separate line item, while others include the deduction on the return under the specific expense.

- The scenario of most concern is the deduction of the expense without the inclusion of the reimbursement as income.
- The other area of importance is, who is responsible for the 50 percent limitation on business meals and entertainment.
- During the pre-audit analysis, the examiner should prepare interview questions pertaining to reimbursed expenses. See [Exhibit B](#). Additionally, the examiner may want to chose potential reimbursable expenses and request an appropriate sample on the initial Form 4564, Information Document Request. See [Exhibit A](#).

## Audit Techniques

The examiner should choose a sample of invoices or contracts and trace the income and reimbursed expenses to the books. This analysis will verify that the income is reported and that a corresponding expense may be deducted. Additionally, while sampling invoices or contracts, the examiner can verify that the taxpayer has properly applied the percentage limitation to all unreimbursed meals and entertainment.

## Law

IRC section 61 is used for the inclusion of income from whatever source derived. IRC section 162 allows a deduction for all ordinary and necessary expenses incurred while carrying on a trade or business.

Treas. Reg. section 1.274-5T(h) discusses the reporting and substantiation of certain reimbursements of persons other than employees. This includes reimbursement arrangements with a client or customer.

IRC section 274(n) generally requires that the amount of an otherwise allowable deduction for the cost of business entertainment and meals be reduced by a flat 50 percent, unless these expenses are being reimbursed by a client.

## Uniform Issue Numbers

- Gross income versus net gross income
- Reimbursement for expense - non employee
- 162-00-00 Business Expenses
- 274-01-00 Entertainment, amusement or recreation
- 274-03-00 Traveling
- 274-08-00 Substantiation

## Glossary of Terms

**Downsizing** - The term used by companies who are permanently eliminating jobs in an effort to decrease costs.

**Hybrid Company** - A consulting firm that provides other services or goods. An example is: a computer consulting firm that provides computer consulting services, as well as, the sale and installation of the computer hardware and/or software that they have recommended.

**Job Broker** - Firms who provide independent consultants to various subcontractors.

**Networking** - A marketing tool used by consultants to generate word of mouth referrals. This is done by engaging in activities with other professionals in various industries.

**Reimbursed Expenses** - Expenses incurred by the taxpayer which are billed to their client.

**Rolodex System** - A collection of companies and/or other individuals with different expertise that a person can refer to in order to obtain various services needed in their company. Normally, there is an informal agreement to make use of each other's services whenever possible.

**Strategic Alliance** - An affiliation with other companies whose expertise varies from their own. This is done with the intent of providing full service to a client. Each affiliate works as a member of a team to fulfill the requirements of a contract. Such an alliance allows members of the alliance to provide "one stop shopping" for a client and creates a virtual company.

**Value Based Arrangement** - A payment arrangement used by some consultants where the consultant makes the up-front investment in work and does not charge the client until the promised benefits are realized.

# Exhibit A

## Description of Documents to be Requested

### Income

- Request copies of all Forms 1099, including Forms 1099-B.
- Request copies of either all consulting contracts or select a sample of the contracts.
- If the consulting business is a sole proprietorship, or a single member disregarded entity filing as a Schedule C, request copies of all corporate or partnership tax returns that the taxpayer has an ownership interest.
- If the consulting business is a corporation or partnership, request copies of all shareholders or partners that have a 20% or more ownership interest in the entity.
- Request complete copies of financial statements, including footnotes.
- Request taxpayer's work-papers that reconcile profit and loss per books and records to Schedule M-1, Line 1 or Schedule C, Net Profit or Loss.
- Request internet addresses of all taxpayer Web sites.

### Travel

- Appointment Book/Calendar
- Brochures, itineraries for conventions/seminars
- Employee accounting for regular substantiation i.e. tickets, hotel bills, etc.
- Company policy related reimbursement of employee travel expenses.

### Reimbursed Expenses

- Request client contracts or invoices. The reason for this is to:

1. Verify that the taxpayer is reporting the income so that they can take the corresponding deduction or to verify that the taxpayer is properly netting the income from reimbursed expenses vs. the incurred expense.
2. To verify that the expenses is not subject to the limitation because it has been reimbursed.

## **Meals/Entertainment**

- Appointment Book/Calendar
- Client contracts/invoices (This is to verify that the expense is not subject to the limitation because it has been reimbursed.)

## **Personal Service Corporation**

- Request a sample of each type of contract.
- Stock Record Book

## **Independent Contractor vs. Employee**

- Contracts between the taxpayer and clients.
- Contracts between the taxpayer and individuals who provide services on a regular basis.

# **Exhibit B**

## **Interview Questions**

Not all of these questions will be appropriate in every case. Examiners should use this information as a guide and ask only those questions which are appropriate and relevant for their specific case.

**(The following questions pertain to consulting activities only. See IRM 4.10.4.3.3 & 4 for generic interview questions.)**

**(See IRM Exhibit 4.10.4-7 for interview questions associated with e-commerce activities)**

**(See I.R.M. 4.10.3.2.1-7 for interview topics such as Where to Conduct Interview, Preparing and Planning for Interviews, Interview Techniques, Documenting Interviews, etc.)**

1. Question the taxpayer regarding business policies and practices for:
  - Billing rates and billable hours per year
  - Explanation of how retainer fees are determined in contract agreements
  - Explanation of how and when consulting fees are earned and billed
  - Does the Taxpayer provide consulting services without a signed contract?

- Do customers ever enter into consulting agreements with the Taxpayer in which the customer requests the services of a specific employee
  - Do the consulting agreements have cancellation provisions if a particular consultant dies?
  - Does the Taxpayer have employment contracts with all of its consultants?
2. Question the taxpayer as to web site addresses.
  3. Question the taxpayer as to whether deductions have been claimed on the return that are common to e-commerce businesses, such as depreciation for networking equipment or high telecommunications expenditures, or payments to an Internet Service Provider (ISP) or an Application Service Provider (ASP).

## **Bartering**

1. Ask about barter memberships and barter activity during the initial interview.
2. Did the Taxpayer receive any Forms 1099-B?
3. If you have a participant in a barter exchange, Inquire:
  - What does the taxpayer trade?
  - How often are trades made?
  - Are the trades reflected in the books and records?
  - How and when are the trades reflected in the books and records?
  - Does the exchange provide statements to the taxpayer?
  - How often are the statements received?

## **Travel**

- Who are your major clients?
- Where is your client base located geographically?
- How often do you or your employees travel?
- Who travels for the company?
- Are they allowed to bring a companion? If so, who and why?
- Do employees receive a monthly flat fee or per diem for travel?
- Are employees required to account to their employer for their travel?

## **Reimbursed Expenses**

- How are reimbursed expenses run through your accounting records?
- The examiner will ask the taxpayer to walk them through a transaction.

## **Meals/Entertainment**

- Do you have a policy on meals and entertainment?
- Do your clients reimburse for meals and entertainment?
- Are you aware that the applicable percentage limitation applies (currently 50%) to meals and entertainment even while in travel status?

- How are these reflected in your accounting records?

## Personal Service Corporation

- What are the business activities? (Get specific details on each business activity.)
- What percentage of time and/or gross receipts applies to each business activity?
- What type of finished product does the taxpayer deliver?
- How is the contract price determined? (hourly rate, commission, contingent)
- Is the corporation closely held? If so, by whom?
- What percentage of time do the shareholders/employees work for this corporation?
- What does each stockholder do?
- What percentage of your employees perform consulting services?

## Not for Profit

- How long have you been in business and what is your profit/loss history?
- Why did you get into this business?
- Questions need to be asked concerning the 9 relevant factors at Treasury Reg. 1.183-2(b) (Tax examiner will want to read the regulations in depth)
- Manner in which the taxpayer carries on the activity. (Is it performed in a businesslike manner?)
- Taxpayer's expertise
- Time and effort expended by the taxpayer on the activity
- Expectation that assets used in the business will appreciate
- Success of taxpayer carrying on other similar or dissimilar activities
- Taxpayer's history of income/losses with respect to the activity in question
- The amount of occasional profits, if any, which are earned
- Financial status of the taxpayer
- Element of personal pleasure or recreation

## Independent Contractor vs. Employee

(Note: The primary area of concern is control)

1. First potential issue:
  - How did you get into this business?
  - Who are your major clients?
  - (Follow-up questions if it appears the issue may be present i.e.: one major client) - The examiner should tailor their questions to incorporate behavioral control, financial control and the relationship of the parties. See [Exhibit D](#) regarding the categories of evidence.
2. Second potential issue:
  - Review with taxpayer what makes up the contracting expense, consulting expense, etc.
  - How many different individuals and/or corporations provide these services?

- (Follow-up questions if it appears the issue may be present, i.e.: one or few individual providing services to the taxpayer.)
- The examiner will need to ask questions regarding behavioral control, financial control and the relationship of the parties. See [Exhibit D](#) for the categories of evidence.

## Exhibit C

### Internal Control Questions

(Refer also to I.R.M. 4.10.3.4)

Examiners must have a clear understanding of the three key elements of the taxpayer's business. These key steps are:

- Understanding the control environment,
- Understanding the accounting system, and
- Understanding the control procedures.

### Control Environment

- How does the business operate? (The examiner should be able to flowchart the business operations in a manner similar to I.R.M. Exhibit 4.10.3-2).
- How is the business structured?
- Does the taxpayer conduct any business with any related entities?
- How does the taxpayer determine that related party transactions are at arms length?

### Accounting System

- What is the flow of income transactions? (i.e; a contract is signed, check for retainer fee is received by business, employee X endorses check, check for retainer fee is deposited into bank by employee Z, check for retainer fee is posted to sales journal, etc.)
- What is the flow of the expense transactions? (See item above)
- What accounting records are involved in the process?
- How are these transactions reported?

### Control Procedures

- What controls does the business have in place to assure the business operates as intended?
- Are there separation of duties? (i.e; the employee responsible for recordkeeping does not have control over the asset)
- Is there supervision of work?

- Are there periodic reviews by independent third parties?
- Are the transactions recorded timely? (i.e; are January transactions posted to the general ledger late in the year?)

## **Exhibit D**

### **Employee or Independent Contractor (Category of Evidence)**

#### **Behavioral Control**

##### Instructions

1. Type of Instructions:
  - When to do the work
  - Where to do the work
  - What tools or equipment to use
  - What workers to hire to assist with the work
  - Where to purchase supplies or services
  - What work must be performed by a specific individual (including ability to hire assistants)
  - What routines or patterns must be used
  - What order or sequence to follow
2. Prior Approval
  - Requirement to secure prior approval before taking certain actions
3. Degree of Instruction
  - Extent of the detail of the instructions given to the worker
  - Effect on the worker in the event of noncompliance
4. Presence of Instructions or Rules Mandated by Governmental Agencies or Industry Governing Bodies
  - Did the business impose the instructions or rules only in compliance with governmental or governing body regulations
  - Did the business adopt more stringent rules or regulations than those imposed by governmental agencies or governing bodies
5. Instructions by Customer
  - Did the business pass on instructions given by the customer
6. Suggestions vs. Instructions
  - Is compliance with suggestions mandatory
7. \* Business Identification
  - Reason for requiring the worker to wear a uniform or placing business name on vehicle, i.e. reassurance to customer, security purposes
  - Who incurs the expense
8. \* Worker's Occupation
9. \* Nature of the Work

- Degree of direction and control required by virtue of the work itself

*\*These aspects may be neutral in the determination of the worker's status.*

1. Evaluation Systems
  - Measurement of Compliance with Performance Standards
    - Influence on worker's behavior in performing the details of the job
2. Training
  - Type of Training
    - What procedures to follow in performing the task
    - What method to use
    - Updates on company policies, governmental rules or regulations, statutes, orientation, general information sessions
    - Is attendance mandatory
    - Is the worker compensated for attending the training

## **Financial Control**

1. Significant Investment
  - Nature of Business
    - Type of business
    - What assets are normally acquired for the business
    - How the assets are normally acquired, i.e. purchased, leased
    - Other expenditures normally encountered in the business
    - How are the cost determined, i.e. FMV or FRV, arm's length transaction
2. Reimbursed v unreimbursed expenses
  - Who bears the costs of the assets and expenditures mentioned above
  - Which expenses are not reimbursed
3. \* Availability of Services
  - Whether the worker advertises his/her services
  - Location of the business
  - Whether the worker is available to work for the relevant market
4. Method of Payment
  - Salary or hourly
  - Flat fee
  - Commission
5. Realization of Profit or Loss
  - Freedom of choice to make decisions which have an impact on the worker's ability to realize a profit or loss

*\*These aspects may be neutral in the determination of the worker's status.*

## **Relationship of the Parties**

- a. Intent of the Parties
  1. Contractual Relationship

- Consider substance over form
- 2. Information Returns
  - Form W-2
  - Form 1099
- 3. Incorporation
- 4. Benefits
  - Paid vacation days
  - Paid sick days
  - Health insurance
  - Life and/or disability insurance
  - Tax-qualifies retirement plan; Sec 403(b) annuity; other pension plan
  - Cafeteria plan
  - Status determined by state or federal agencies for purpose of providing benefits
- 5. Discharge/Termination
  - Limitation on ability of the business to terminate worker
  - Limitation on ability of the worker to terminate working relationship
  - Worker's liability as result of non-performance
  - Business's rights in non-performance by worker
- 6. Regular Business Activity v Services Performed by Worker
- b. Term of the Relationship
  - 1. Definite v Indefinite Period
    - Long-term
    - Temporary
    - Written contract

### **Facts of Lesser Importance**

- Full-Time v Part-Time
- Place of Work
- Number of Work Sites
- Hours of Work

## **Exhibit E**

### **Internal Revenue Code Section 530**

- A. Reporting Consistency
  - Did the business timely file all required tax returns with respect to the worker (including information returns, Forms 1099) for the period under examination on a basis consistent with the business's treatment of the worker as not being an employee?
- B. Substantive Consistency
  - Worker, or Class or Workers, currently treated as independent contractors.
    - 1. Duties:
      - Current

- Previous
  - 2. Responsibilities
    - Current
    - Previous
  - 3. Supervisor or Manager & Title
    - Current
    - Previous
  - 4. Degree of supervision & control required
    - Current
    - Previous
- C. Reasonable Basis
1. Safe Havens:
    - Prior Examination
      - a. Type of examination
      - b. When was the examination conducted
      - c. Were same class or workers currently under consideration, treated as independent contractors during the period covered by the prior examination
      - d. Did taxpayer reasonable rely on the prior examination
    - Judicial Precedence or Published Ruling
      - a. When did the business begin
      - b. When did the business first begin treating its workers as independent contractor
      - c. Facts in the case similar to the business's situation
      - d. Date of the ruling
      - e. Did taxpayer reasonably rely on the ruling
    - Technical Advice Memorandum, Private Letter Ruling, or other
    - Determination Letter
      - a. To whom/what entity was the ruling issued
      - b. Were the facts materially misstated or omitted
      - c. Any substantial change in the facts since the ruling was issued
      - d. Did taxpayer reasonably rely on the ruling
    - Long Standing Recognized Practice of a Significant Segment of the industry
      - a. When did the business begin
      - b. When did the business first begin treating its workers as independent contractors
      - c. How were the workers previously treated
      - d. Define the industry
      - e. How long has the industry existed
      - f. When did the industry begin this practice
      - g. Define the geographic/metropolitan area of the industry
      - h. How prevalent is the practice in the industry
        1. Number of firm engaged in this practice
        2. Number of workers involved
        3. Homogeneity of the industry

- i. When did the industry's practice change, if applicable
  - j. Did taxpayer reasonably rely on the industry practice
- 2. Other Reasonable Basis: (More than mere "good faith" is required for section 530 relief. "Good faith" may be basis for not asserting penalties.)