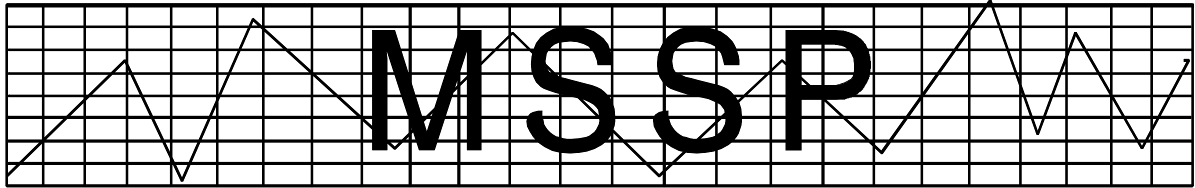

Market Segment Specialization Program

Manufacturing Industry

The taxpayer names and addresses shown in this publication are hypothetical. They were chosen at random from a list of names of American colleges and universities as shown inWebster's Dictionary or from a list of names of counties in the United States as listed in the United States Government Printing Office Style Manual.

This material was designed specifically for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position.

Department of the Treasury
Internal Revenue Service

Training 3147-115(5/98)
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Manufacturing

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Chapter 1

INTRODUCTION

PURPOSE

The purpose of the guide is to provide the examiner with techniques to audit manufacturing businesses in an efficient, effective, and intelligent manner.

These audit techniques are outlined in a step-by-step fashion and explained in detail. Basic audit steps such as reconciliations, balance sheet analysis, and the initial interview have been integrated into this guide so that an examiner can read a training manual or the Internal Revenue Manual (IRM) and see how audit steps are implemented in the course of an audit. Every attempt was made to include citations from the Internal Revenue Code, Treasury Regulations, Revenue Rulings and Procedures, and the IRM so the examiner could be assured of locating the basis of any conclusion drawn. Much of the information will be a basic review for many experienced examiners. However, this guide has some specialty items that will help them.

This guide should be useful in the audit of any manufacturing business. However, it does not address unique aspects of a particular industry. In those instances, the examiner should review the MSSP Guide for that industry. If there is no MSSP Guide, contact the MSSP coordinator or Industry Specialist for additional information.

HOW THIS GUIDE IS PRESENTED

This guide is set up to match the natural progression of an income tax audit for field examination. It begins with the planning stages of the audit and continues through the package audit, balance sheet, sales, inventory, and expense.

Special emphasis has been placed on changes in accounting methods, IRC section 263A, and inventory because they exist in most audits of a manufacturing business.

Awareness discussions include LIFO, Research and Development Credit, unique items (tool and die business), production greater than 12 months, and self-constructed assets. These discussions are given less emphasis because they do not exist in the majority of audits of a manufacturing business. In those cases, there are other MSSP Guides and resource material available. Based on district procedures, contact either a

revenue agent experienced in this market segment, the MSSP coordinator or the Industry Specialist for additional information.

MANUFACTURING

A manufacturer is one who converts raw materials into finished goods.

This market segment contains the following industries:

1. Food and Kindred Products -- Meat, dairy, preserved fruits and vegetables, grain mill products, beverages, etc.

2. Tobacco Products -- Cigarettes, cigars, etc.

3. Textile Mill Products -- Broadwoven and narrow fabric mills, textile finishing, carpets and rugs, etc.

4. Apparel and Other Textile Products -- Clothing, hats, coats, furs, etc.

5. Lumber and Wood Products -- Logging, sawmills, wood buildings and mobile homes.

6. Furniture and Fixtures -- Household, office, etc.

7. Paper and Allied Products -- Pulp, paper, paperboard, converted paper products, etc.

8. Printing and Publishing -- Newspaper, books, business forms, greeting cards, etc.

9. Chemical and Allied Products -- Plastics, drugs, soaps, paints, fertilizers, adhesives, explosives, etc.

10. Petroleum and Coal Products -- Petroleum refining, asphalt and roofing materials, lubricating oil and greases, etc.

11. Rubber and Misc. Plastics Products -- Tires, footwear, hoses, belts, misc. plastic products, etc.

12. Leather and Leather Products -- Tanning and finishing, footwear, gloves, luggage, handbags, etc.

13. Stone, Clay, and Glass Products -- Glassware, cement, brick, pottery, concrete,

gypsum, plaster, etc.

14. Primary Metal Industries -- Steel, iron, copper, aluminum

15. Fabricated Metal Products -- Cans, cutlery, tools, screws, bolts, nuts, etc.

16. Industrial Machinery and Equipment -- Engines and turbines, farm, garden, construction, computers, office equip, etc.

17. Electronic and Other Electric Equipment -- Transformers, motors, appliances, lighting fixtures, audio and video, TV, radio, batteries, etc.

18. Transportation Equipment -- Motor vehicles, truck trailers, motor homes, aircraft and parts, ships, railroad equipment, motorcycles, bicycles, space vehicles, etc.

19. Instruments and Related Products -- Search and navigation, measuring and controlling, medical, photographic, etc.

20. Miscellaneous -- Jewelry, silverware, plated ware, musical instruments, toys, sporting goods, office and art supplies, burial caskets, etc.

Principal Industry Activity (PIA), Principal Business Activity (PBA) and Standard Industrial Classification Codes (SIC)

Principal Industry Activity (PIA) Code

A four digit code used by the IRS to define industries doing business as a sole proprietorship. The returns are self-coded. There are a total of 183 codes.

Principal Business Activity (PBA) Code

A four digit code used by the IRS to define industries doing business as a partnership or a corporation. This term is used interchangeably with PIA. The returns are self-coded. There are 199 codes for partnerships and 187 codes for corporations.

Standard Industrial Classification (SIC) Code

A four digit code developed by statistical agencies (Census, Bureau of Labor). It is used to define industries and classify individual establishments by industry. Codes are assigned by the agency. There are 1,005 codes.

See Exhibit 1-1 at the end of the chapter for the codes applicable to manufacturing.

Audit Technique Guides (ATG)

The following ATG's for manufacturing are currently available on the MSSP bulletin board:

- Garment Contractors
- Garment Manufacturers
- The Wine Industry
- Furniture Manufacturing
- Commercial Printing

Anyone who has access to the MSSP Bulletin Board can download an ATG. If the examiner does not have access to the bulletin board, contact the district MSSP coordinator who should have access to the MSSP Bulletin Board.

Industry Specialization Program (ISP)

ISP was designed for the Coordinated Examination Program (CEP) but it can benefit anyone. ISP Industry Digests, position papers, and other information files are located on the MSSP Bulletin board and the ISP Bulletin Board. The district ISP coordinator should have access to both of these bulletin boards.

The district ISP coordinator should have a list of the national ISP coordinators, industry coordinated issues, and industry significant issues. These lists are also available on the National Office bulletin board.

An industry coordinated issue is an issue that is always present and has to be raised during an examination.

In addition to the industry coordinated issues, there are also industry significant issues. An industry significant issue is an issue that could be present.

Depending on district procedures, contact the district ISP coordinator or the national ISP specialist if further information is needed on ISP issues.

MANUFACTURING CLASSIFICATION CODES

	PBA 1120	PBA 1065	PIA Sch C	SIC
Food and Kindred Products	2010, 2020 2030, 2040 2050, 2060 2081, 2088 2089, 2096	2000	6038	2011 - 2099
Tobacco Products	2100	3970	1883	2111 - 2141
Textile Mill Products	2228, 2229 2250, 2298	2200	0653	2211 - 2299
Apparel & Other Textile Products	2315, 2345 2388, 2390	2300	0679	2311 - 2399
Lumber and Wood Products	2415, 2430 2498	2400	0836	2411 - 2499
Furniture and Fixtures	2500	2500	0810	2511 - 2599
Paper and Allied Products	2625, 2699	2700	0877	2611 - 2679
Printing and Publishing	2710, 2720 2735, 2799	2700	0851	2711 - 2796
Chemicals and Allied Products	2815, 2830 2840, 2850 2898	2800	1883	2812 - 2899
Petroleum and Coal Products	2910, 2998	3970	1883	2911 - 2999
Rubber & Misc. Plastic Products	3050, 3070	3000	1883	3011 - 3099
Leather and Leather Products	3140, 3198	3100	0695	3111 - 3199
Stone, Clay and Glass Products	3225, 3240 3270, 3298	3200	1032	3211 - 3299
Primary Metal Industries	3370, 3380	3300	1057	3312 - 3399
Fabricated Metal Products	3410, 3428 3430, 3440 3460, 3470 3480, 3490	3400	1073	3411 - 3499

Exhibit 1-1 (2 of 2)

	PBA 1120	PBA 1065	PIA Sch C	SIC
Industrial Machinery and Equip.	3520, 3530 3540, 3550 3560, 3570 3598	3500	1099	3511 - 3599
Electronic & Other Electric Equip.	3630, 3670 3698	3600	1115	3512 - 3699
Transportation Equipment	3710, 3725 3730, 3798	3700	1883	3711 - 3799
Instruments & Related Products	3815, 3845 3860	3970	1883	3812 - 3873
Misc. Manufacturing Industries	3998	3970	1883	3911 - 3999

Chapter 2

UNDERSTANDING THE PRODUCTION PROCESS

INTRODUCTION

This chapter provides information in identifying potential issues through tax return analysis. Also provided is information for the preparation of document requests and interview questions applicable to a manufacturing business.

It is very important to know what type of manufacturer is the taxpayer and which cost method does the taxpayer use. This will help in determining which interview questions to ask and in understanding how the production process relates to the flow of documents.

TYPES OF MANUFACTURERS

There are three different types of manufacturers:

1. **Custom**

   These companies produce goods to customers' specifications. Production and inventory levels are on a job by job basis. Custom companies may or may not have inventory.

2. **Production**

   These companies produce goods on a continuing basis. They maintain a specific level of inventory. The companies may produce a catalog (generally bound or in loose leaf form) showing their different product lines and customers place orders from that catalog.

3. **Combination**

   Companies who produce goods based on a combination of custom and production as described above.

COSTING METHODS FOR MANUFACTURING

Manufacturers use one of three methods for costing inventory:

1. **Job Order Costing**

   Products are readily identified by individual units or batches. These units or batches receive varying inputs of direct materials, direct labor and indirect costs. Costs are collected according to the job or customer. Examples of job order costing include printing, aircraft manufacture or furniture manufacturing.

2. **Process Costing**

   Products are homogenous and not particular to any one customer. Production is continuous through a series of production steps. Costs are charged directly to the responsible department or process. Examples of process costing include the manufacture of oil, paint, or rubber.

3. **Operation Costing**

   Used in the manufacture of goods that have common characteristics plus some individual characteristics. Examples of operation costing include shoes, clothing, or textiles.

PLANNING THE AUDIT

The objective of pre-audit planning is for the examiner to become familiar with items on the tax return and to provide a solid foundation for the audit. The Tax Audit Guidelines for Internal Revenue Examiners (IRM 4231) can be consulted for pre-audit techniques. The pre-audit planning should include the following:

1. Identification of potential issues/tax return analysis
2. Specialty referrals
3. Comparative year analysis
4. Ratio analysis.

Identification of Potential Issues/Tax Return Analysis

Every audit should begin with a thorough analysis of the tax return. By analyzing the return, the examiner becomes familiar with the company and its characteristics. Knowledge of these characteristics allows the examiner to adjust the initial document request, tailor the initial interview questions to prevent confusion, and determine where the focus of the audit should be and where not to waste time.

The following portions of the return should be considered:

Schedule A - Cost of Goods Sold and/or Operations

Compare the balance sheet amounts, Schedule A (Computation of Cost of Goods Sold) and the financial statements with prior and subsequent year returns available. Are there any discrepancies? Has the taxpayer changed the inventory calculations between returns without making the necessary amendments or requests for permission? Compare the balance sheet amounts with the inventory workpapers. They do not always agree.

Always note the methods used for valuing closing inventory. Specialty boxes checked such as LIFO inventory method may require pre-audit research of IRC section 472 or consultation with LIFO specialists. The initial document request may require modification to include the Form 970 (Application to Use LIFO Inventory Method) and the LIFO index workpapers prepared by the taxpayer.

During the pre-audit, perform a comparison of the pre-UNICAP return to the return where IRC section 263A is first applicable to review the changes. There should be significant changes in certain expense items being capitalized for IRC section 263A depreciation. Interest expense, officers' salaries, and an allocation of general and administrative expenses were not required to be capitalized under full absorption. Beginning inventory should be restated in the first year of IRC section 263A.

Scan the Schedule A, Cost of Goods Sold, for unusual figures. A zero inventory balance is highly unusual for a manufacturer.

Audit emphasis should be placed on certain pre)substantive audit procedures which then determine the depth and scope of the examination of production costs. If several steps are involved in the manufacturing process, the examination of cost of sales is time consuming, detailed, and often complex. Care should be taken early in the examination when the determination is made to pursue an inventory or cost of sales issue.

A solution to the audit cost/benefit dilemma is the formulation and implementation of standard preliminary audit procedures that address cost of sales. Always keep in mind that materiality, consistency, and timing (in that order) are primary considerations in deciding whether to pursue an issue.

Other Income

Taxpayers are required to restate (increase) beginning inventory for the first year of IRC section 263A. This increase is taken into income, generally, over a period of 4

years. Does the other income account include the IRC section 481(a) amount? Does the taxpayer sell any by-products?

Schedule E - Compensation of Officers

Note the officers and their respective salaries. A question about the officer's respective duties may be in order. Determine if any amount is capitalized to inventory. Due to the changes required by IRC section 263A, a higher percentage of wages should be capitalized (reflected in the Cost of Goods Sold computation) than expensed directly. If the return prior to IRC section 263A is available, compare the percentages.

Repairs

Under IRC section 263A, repairs to production assets must be capitalized to inventory.

Rent

Under IRC section 263A or full-absorption, rent on production assets must be capitalized to inventory.

Taxes

There are generally four main categories of taxes for manufacturers. These are payroll taxes, real estate taxes, excise taxes, and income taxes. Payroll taxes should be capitalized to inventory in the same ratio as the wages to which they relate. Real estate taxes on production assets should be capitalized to inventory per IRC section 263A. Income taxes are specifically excluded from capitalization under IRC section 263A.

Interest Expense

Per IRC section 263A, interest expense needs to be capitalized to inventory if the production period exceeds 2 years, or, if the value (cost) exceeds $1 million and the production period exceeds 1 year. See Rev. Proc. 95-19, 1995-1 C.B. 6.

Advertising

Generally, amounts expended for advertising and promotion are currently deductible. However, the account should be reviewed for label development costs and, in closely held entities, for personal expenses.

Pension/Profit Sharing Plans and Employee Benefits

These costs should be capitalized in the same ratio as the wages from which they came.

Other Deductions

Some preparers use this section to show the total capitalization of expenses to inventory, including amounts capitalized on the expenses listed above. In some cases, the amount of capitalization exceeds the total of "other expenses," resulting in a negative amount. Since this total amount of capitalization cannot be traced to any specific account, it is difficult to isolate any expenses in the pre-audit that appear to warrant attention. If that is the case, you will need to wait until a breakdown is received from the taxpayer.

Some preparers provide a schedule of capitalized costs as an attachment to the return. This schedule shows the total amount of an expense, and an individual breakdown of the amount capitalized and the amount expensed. This type of schedule can be very helpful in the pre-audit to determine the scope of the review of the taxpayer's application of IRC section 263A.

In addition, review this account for other items that should be capitalized to inventory, such as supplies, utilities, insurance, contract labor, production related consulting/professional fees, storage or warehousing costs and other indirect production costs.

Professional Fees

Review professional fees for items such as label development costs and trademark costs (no longer deductible), legal fees associated with the acquisition of assets and any other capitalizable costs.

Costs that are generally deductible currently include indirect costs of the sales/marketing department, sales commissions to distributors and other advertising, promotion, or marketing costs.

Credit Memos and Debit Memos

Credit memos issued by the manufacturer usually cover shortages, returns, price variances, or damages of invoiced goods. Credit memos are sometimes used to charge back all or part of freight charges. Copies are generally attached to the purchase invoice.

Credit memos are also issued by the retailer to the manufacturer to cover returns, shortages, or any kind of allowance claimed on a shipment of finished goods. A notation may be kept with the sales invoice or the document may be submitted to a factor and filed with the monthly statement. A factor is a party that lends money on accounts receivable, or buys and collects accounts receivables.

Debit memos are sometimes issued to correct erroneous credit memos or acknowledge receipt of excess goods or an incorrect price. They may also be issued to customers to adjust a shipment price.

Buildings and Other Depreciable Assets (Fixed Assets)

Many manufacturing industries are capital intensive. A lack of assets could be an indication that the taxpayer is renting assets from a related party. If production assets are being rented, this rent should be capitalized to inventory.

Review the depreciation schedule for:

1. Adequate capitalization of depreciation to inventory
2. Useful lives on buildings (sometimes claimed to be essentially equipment)
3. Personal residences being depreciated
4. All development costs being capitalized
5. Placed in service dates.

Interest Bearing Debt in General

Compare the amount of debt with the amount of interest expense. Is it reasonable? If the taxpayer produces products with a long production period, is a portion of the interest being capitalized? Under IRC section 263A, interest should be capitalized under the avoided cost method.

Additional Information

Read through the questions and the answers on the tax return. Pertinent information regarding the business activity, ownership interests and accounting methods may be obtained.

Schedule M-1

The pre-audit analysis of the tax return includes a scanning of the M-1 reconciliation. Note the items included on the M-1 as well as the items not shown.

Review the balance sheet for any indication of a potential deferred revenue issue. First

inspect the liability section of the balance sheet paying special attention to the statements detailing the line items. If the taxpayer is deferring revenue, there is a credit balance in some liability account. Most likely the deferred revenue is included in "Other Current Liabilities." Or, the taxpayer may include it in any other liability account such as "Other Liabilities."

Review Schedule M to see if the revenue that was deferred per the balance sheet was added to taxable income. The presence of deferred revenue on the balance sheet does not necessarily mean that there is an audit adjustment. The taxpayer may be properly deferring revenue under GAAP rules and reporting the revenue on the tax return.

If there is deferred revenue reported on the balance sheet and no income added back on the Schedule M, there may be an audit issue. The issue should be pursued in the interview with the taxpayer. Even if deferred revenue is added back on Schedule M, still inspect the Schedule M workpapers to ensure that the correct amount was included in income. For example, one taxpayer reported deferred revenue for tax purposes, but reduced this amount by an estimate of future discounts. Even though deferred revenue was reported, there was an audit adjustment in the amount of the estimated future contingent rebates.

Form 5471

The inclusion of the Form 5471, Information Return of U.S. Person With Respect to Certain Foreign Operations, with the tax return indicates the taxpayer owns a foreign corporation.

To stay competitive in the world market, some manufacturers are moving their operations south of the U.S./Mexico border. They establish subsidiaries under Mexico's Maquiladora Program which are commonly referred to as "twin plants," or in Spanish, maquiladoras. By participating in this program, manufacturers are able to take advantage of the lower cost of labor, plant and equipment, as well as the relaxed regulatory requirements in Mexico. In addition, raw materials, supplies, and production equipment may be imported into Mexico free of all duties while title is retained by the U.S. owner.

Specialty Referrals

These include referrals to International, Engineering, or Computer Audit Specialist (CAS). Careful consideration should be given in case of Forms 1120, 1120S, or 1065 returns, with assets in excess of $10 million. If the examiner's case meets this criteria, a referral to the CAS group is necessary. Since the CAS requires time to introduce himself or herself to the taxpayer and to become familiar with the computer system, it is recommended the examiner make a referral before the first appointment.

CAS personnel are very useful in extracting information from the taxpayer's computer system. They can present the data in a form that makes it easier to audit and interpret. Should it be warranted, a referral is made and submitted through the group manager to the CAS Specialty groups.

Comparative Years Analysis

Analyze cost of sales on comparative years basis due to the effects of timing on any potential adjustments.

Form 1120 Schedule A

Prepare a workpaper comparing cost of sales detail for at least three consecutive years and note the following:

1. Changes in dollar amounts from year to year
2. Direction of dollar amount changes
3. Types of costs listed. Are accounts consistent from year to year?

In addition observe if there are any unusual types of accounts. Are the appropriate types of costs listed? The absence of a typical account category may indicate that audit expansion is warranted (that is, no Other Costs listed, no IRC section 263A costs included).

Form 1120 Schedule M-1

Prepare a workpaper comparing the inventory related book to return adjustment detail for multiple years. Note the following:

1. Type of M)1 adjustments -- IRC section 263A with related IRC section 481 adjustment
2. Inventory reserves -- IRC section 461
3. Standard cost variances -- Treas. Reg. section 1.471-11(d)(3)(ii)(a).

Any M)1 adjustment warrants analysis to the extent that it can be determined to be appropriate for the taxpayer's business and is being consistently applied. Be sure to achieve a good understanding regarding ALL M)1 adjustments. Analyze the rationale underlying a difference in book and tax and the effect that any discrepancy may have on tax (noting permanent versus timing differences).

Observe patterns and note material changes (that is, direction of an amount change, account change, material amount changes, account relationships).

Isolate and reconcile IRC section 263A and the associated IRC section 481(a) adjustment to the amount(s) shown on the tax return.

Ratio Analysis

Ratio analysis can be performed from tax return information alone. The computation of the following ratios gives the examiner a good indication of whether an in)depth examination is warranted before looking at any workpapers, journals, or source documents:

1. Compare GROSS PROFIT percent for consecutive years.

   The percentage should be consistent. Changes should be explained.

2. Compute the INVENTORY TURNOVER RATE: COS / (Beg. Inv. + End. Inv. / 2).

   This ratio indicates the number of times a taxpayer's inventory is sold and replenished during a taxable year.

   Under FIFO cost flow assumptions, the reciprocal of the turnover rate will be the percentage of current year costs remaining in ending inventory. If the turnover rate is four, 25 percent (1/4) of current production costs would theoretically be in ending inventory. As the turnover rate increases, the percentage of current costs remaining in ending inventory decreases.

3. Compute the $$DOLLAR$$ percentage (before labor and overhead allocations) of Work)in)Process (WIP) Materials + Finished Goods (FG) Materials / Total Inventory Materials.

   This reflects the percentage of materials started into production and/or materials sitting in finished goods.

   If the ratio is relatively small (less than 30 percent), there is less audit potential because cost allocations, (and possible adjustments), are generally made to "in)process" activity.

   Another way to analyze this is to compare the dollars in raw materials inventories to the dollars in WIP and FG. If the ratio of Raw Materials (RM) is low compared to WIP + FG, adjustment potential is as favorable. Physical count summary workpapers will be needed for this analysis; however, some workpapers may not provide the dollar amounts.

4. Compute the NUMBER OF DAYS SUPPLY IN INVENTORY (365 / Inventory Turnover Rate), which generally measures efficiency.

   Note that most companies set a "days supply minimum" level to be maintained as managerial policy, providing a good indication of expected inventory levels.

5. Make a timing effect determination.

   An inventory adjustment is a timing adjustment. If inventory levels go down in a subsequent year or inventoriable costs change, this may have a favorable effect on the taxpayer. Net effects should be considered. If taxpayer has a compliance problem with regard to the accounting method used, or if a gross under)allocation of cost to inventory is discovered, audit correction is recommended.

INITIAL INTERVIEW

The initial interview is important because it provides an opportunity to obtain valuable information which might not be available later. At this time, you have the opportunity to explain the audit process and gain some background information about the taxpayer. There are some issues where the best developmental information comes at the beginning of the audit while the officer/shareholder is still candid and responsive (that is, accumulated earnings, reasonable compensation, etc.). At this time, explain the use of the information document requests, set a time frame for receipt of responses, and discuss an overall time period for the examination.

The manufacturing MSSP guides provide industry specific interview questions. Review these questions when planning the examination and include many, if not all, with the routine interview questions.

Listening to the responses given by the taxpayers or representative provides opportunities to ask follow-up questions. This is important since the responses to the follow-up questions may result in identifying areas of audit concern.

In addition to asking the appropriate questions, you need to take the time to document responses received during the interview. The responses are factors in determining whether to request assistance from a specialist or whether the assertion of penalties may be warranted. Complete the interview notes as soon as possible after the initial interview.

Interview the Controller, Chief Financial Officer (CFO), Accounting Manager to:

1. Understand the general ledger set-up.

2. Identify activity that is outside the scope of inspection -- overseas production, sub)contracted processes like outside assembly, testing, or engineering.

Interview the Production Manager to:

1. Understand the product.

2. Understand the production process (that is, steps, job functions, sub)contract functions).

3. Identify potential cost types.

See Exhibit 2-1 for questions to assist you with the initial interview. The questions listed do not cover all the potential information to be gathered. This is left to the ingenuity of the examiner. However, these questions provide a solid start and a foundation for future follow-up questions.

TOURING THE FACILITIES

A tour of the facilities is helpful in understanding the business operations. The tour provides a visual picture of the business. It gives you an opportunity to validate information received during the initial interview. If time is limited, it may be preferable to conduct the initial interview while touring the facilities.

During the tour, it is important to observe the operation of the business and its facilities. Keep in mind the initial interview responses and any notes made while pre-auditing the return. The following items may be areas of concentration during the tour:

1. Fixed assets reported on tax return. If fixed assets reported on the tax return are not found on the tour, inquire as to their location or disposal.

2. Match production responses to visual observations. It is extremely helpful if you can see the processes the taxpayer has explained. Matching a visual process with verbal explanations can either raise further questions or clarify them.

The tour of the facilities is an opportunity to verify the overhead allocations made. Since the overhead allocations may be made asset by asset or by square footage, getting a firm understanding of the layout of the facility is essential.

The tour is an excellent time for the taxpayer to tell you about their product line, what varieties they produce, what processes they use, and the use of the different assets.

At this stage of the audit, many facts are gathered that will help determine the existence and potential of income tax issues. As in any type of diverse manufacturing industry, the best way to fully understand the operations and processes of a particular business is to visit the facility. A guided tour by a knowledgeable person who can explain and answer questions about each area of operation is a very effective examination technique.

In the audits of most manufacturers, you will find samples of their work proudly displayed. These samples give you an idea of the company's market niche(s).

During the tour, follow these general procedures:

1. Observe and take notes on the different departments, that is, number of employees, and types of computer systems, and equipment used. Also, notice the source documents generated in each department.

2. Notice displays such as sales awards based on revenue, etc.

3. Note any job scheduling sheets and job tracking sheets.

4. Ask questions as often as necessary to fully understand each process and to gather pertinent information.

5. Confirm testimony with actual activity.

6. Obtain a feel for the size of the operation and the active production observed.

7. Observe the manufacturing areas versus other activity because overhead allocations may be based on this.

8. Note how many work stations are available and how many are in use. Ask if this is typical or is it a busy or a slow season.

9. Note how many machines there are and find out if any are new.

10. Look at the time cards. Are there as many cards as people working? If there are fewer, it may indicate a cash piecework payroll. More might mean the staff was prepared for your visit and/or will work another shift. This might be done to minimize the impression of shop volume.

11. Inspect the existing finished goods, work in process and raw materials inventories, as well as supplies and tooling.

12. Evaluate overall integration of the operations. Information obtained by performing interviews and a tour of the facilities should corroborate each other. Disunity is an indication that further examination should be pursued.

Specific Observations

The following functions are generally present in a manufacturing entity. If during the tour it is noted that they are not present, determine if they are at an off site location or if certain functions are performed by subcontractors. The information gathered during the tour should include the following:

1. Receptionist

   Observe the front desk and types of logs kept by the receptionist.

2. Administrative

   Observe the number of employees, source documents and computer systems for administrative functions, such as:

   a. Accounts Payable
   b. Accounts Receivable/Billing
   c. Accounting and Finance
   d. Data Processing.

3. Customer Service

   Observe the number of employees, source documents, office equipment and computer systems.

4. Sales/Estimators

   Observe the number of salespeople and estimators. Find out what functions they perform. Notice how customer contacts are made and types of source documents generated.

5. Quality Controls

   Notice how quality control systems work within each department. Ask where pre-production supplies, such as chemicals, are stored and note the quantity on hand.

6. Inventories

   The physical inspection is a significant aspect of the performance of the minimum inventory tests described in Chapter 652 of IRM 4235.

   Determine what inventory is kept on the premises and where it is stored, if there are purchases made for subcontractors, or if other off-site locations should also be visited. Types of inventory observed should include:

   a. Raw Materials
   b. Work In Process
   c. Finished Goods.

   Observe the receiving department and source documents generated. Ask to be shown any raw materials that are held on consignment and any finished goods that have already been sold (known as bill and hold items). Look for damaged goods and used raw materials. Note any sections marked as hazardous waste areas.

7. Machinery Set-up

   Observe the set-up processes performed in preparing the machines such as cleaning or loading raw materials. Make note of how the set-up procedures are documented (time logs, etc.). Note the number of employees involved. Find out whether the set-up process is a separate cost center or if it is combined under one cost center.

   Look for any machinery not running and determine why it is not in use. Note any specialty type machinery. Notice the age of the machinery and the technical advancement. Observe and inquire about any equipment that could have been refurbished or newly purchased. Look for real-time monitors attached to the machinery and other computer equipment which tracks the machine hours. Note scheduling boards and/or cards.

8. Post Production Process

   Observe equipment used for post production processes such as packaging. Ask if any of these services are performed elsewhere if not seen on the premises. Note the number of employees and any separate scheduling sheets.

9. Shipping

   Observe shipping trucks, source documents, log books and the number of employees in the shipping department. If present, take notes of any delivery trucks

that may require highway use tax (number of axles, etc.). Follow local required filing checks for potential excise tax issues. Notice the use of common carriers and separate logs for shipping in that manner.

A tour of the business premises during the workday enables the examiner to get a clear idea of the production operation and provides information that is of use in development of issues later. Ask for clarification of anything that is not described to you. This is the taxpayer's opportunity to show off his or her business. Friendly and curious questions usually receive a complete and ready response.

FLOWCHARTING THE PRODUCTION PROCESS AND RELATED SOURCE DOCUMENT FLOW

In examinations of manufacturing companies, it is critical to gain an understanding of the work flow during the initial interview and tour. This is especially useful in the examination of the cost of sales. As the costs are incurred during the production processes, the paper trail generally follows. Documenting the production process through a simple flowchart is a useful audit technique. The production process can then be compared to the flow of the source documents generated. This helps determine for example, whether income recognition is being deferred by not billing goods already shipped or whether a cost center is being omitted from ending inventory.

The records available during the examination of these businesses range from manually maintained records to in house developed computer systems, to sophisticated computer software management systems designed specifically for a specific manufacturer. Many manufacturers are changing to electronic production. Any of the following systems may be seen on computerized records:

Estimating/Quotation	Invoicing
Job Tracking	Account Receivables
Scheduling	Account Payables
Inventory Control	Purchasing
Work In Process	General Ledger
Finished Goods Inventory	Financials
Production Forms	Payroll
Cost Center Costing	Bank Reconciliations
Real-Time Data Collection	Shipping/Lading

The larger the manufacturer the more that the accounts are broken down into sub-accounts. For example, in recording outside service expenses the smaller manufacturer would normally use only one account for outside services. The larger manufacturer would break down outside services into specific subsidiary accounts.

The paper trail may begin upon customer contact with a completed specification sheet which clarifies what the customer wants.

For example, in the commercial printing industry, an estimate of the costs is computed by the estimator. A markup is added and a quote is then given to the customer. Upon acceptance by the customer, the production of the job is scheduled. During the tour, the examiner may notice the scheduling boards on the wall. The production manager keeps track of work in progress via production schedule sheets.

The direct material and labor costs are generally recorded as incurred. While the job is moving through each department, the costs incurred such as hours worked and materials used are recorded on the job cost sheet which is generally attached to the front of the job jacket. In the plant there may be terminals where an employee logs in their employee number and the job number, making hand written time sheets unnecessary. Supply expenses may not be charged to a specific job. Upon completion of the job, the shipping department arranges for delivery. In this department you may see a shipping schedule, a common carrier log book, or delivery tickets.

Because records are increasingly kept on magnetic media, the traditional hard copy ledger and journals are not found in many cases because taxpayers do not print them in their normal course of business. Rev. Proc. 91-59, 1991-2 C.B. 841, makes it clear that the machine-sensible data media used in automatic data processing of accounting records constitute records within the meaning of IRC section 6001. You may encounter some systems that are changing and do not have all of the source documents available. Data may not be maintained which was used at yearend. An example of this is a job cost system where standards are changing periodically, but are not retained. This could make it more time consuming to examine inventory valuation.

Rev. Proc. 91-59, 1991-2 C.B. 841, provides some guidelines for record requirements where some of the records are maintained by an automatic data processing system. One specific requirement is found in section 5.11:

> **The taxpayer must be able to process the retained records at the time of a Service examination. Processing shall include the ability to print a hard copy of any record. When the data processing system that created the records is being replaced by a system with which the records would be incompatible, the taxpayer shall convert pre-existing records to a format that is compatible with the new system. * * ***

The above cite points out several problem areas which may be encountered. The taxpayer may have changed software or hardware making the retained records incompatible with the current system. It is the taxpayer's responsibility to make the records compatible to the new system. Where basic hard copies are not available at the beginning of an examination, immediately request the printed records needed.

The Computer Audit Specialist can offer assistance in this area. For example, the specialist may be able to get the necessary files and retrieve data which is needed, leaving the taxpayer's routine undisturbed.

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QUESTIONS FOR THE INITIAL INTERVIEW

General Information and Compliance Questions

Were any relatives of the shareholders employed by the corporation? In what capacity? What were their duties?

What types of fringe benefits are provided to the employees such as life insurance coverage, medical or dental plan premiums, company vehicles, auto allowances?

How does the company obtain new customers? What economic conditions, if any, have affected the business of the company?

At what point are accounts determined to be bad debts? What collection efforts are made?

Background

Describe your business units and market niche for each unit.

Within your market niche(s) do you have any peak or slow periods?

If so, when are you the busiest? When are you the slowest?

Do your operations ever shut down? If so, when?

Have you bought any businesses in the last three years?

Have you sold any assets or businesses in the last three years?

If so, why did you buy or sell any businesses?
How many employees, by job category/department?

How many jobs are normally going on at one time?

Records

How do you control and track your jobs?

What type of source documents are there for the different departments?

How are your sales invoices filed?

How are your delivery tickets filed?

Do you use software programs? If so, for what functions (both accounting and non-accounting)?

What programs and systems are interfaced?

Maquiladora Operation

Who owns the foreign corporation?

Does the foreign corporation have a built in profit margin?

How is the price of goods sold to the domestic company set?

Does the taxpayer pay for any expenses on behalf of the maquiladora?

Manufacturing Process

What type of goods are manufactured? Any by-products produced?

What is the actual process?

1. Where are materials purchased from?
2. What are the labor processes?
3. Is there quality control and/or inspection?

Is there any scrap material? Any production of a by-product?

Is any part of the manufacturing process done by subcontractors? If so, what part(s)?

Is production determined by customer order or is inventory maintained at a certain level?

Are any goods imported from overseas?

Is there more than one manufacturing facility? Is it offsite? List locations.

How do you account for labor? (How do they keep track of capitalized versus expensed costs?)

Inventory

Do you have a cost accounting system? If so, provide a narrative.

Did you have any write-downs of your inventory?

Is a physical inventory taken? If so by whom, when, and how is it valued?

Are any goods placed on consignment?

Do you maintain an inventory of finished goods?

How large is the work-in-process (WIP) inventory?

What inventory records do you maintain?

Showroom on/off premises:

- If there is a showroom on the premises, this may affect the uniform capitalization computation. If there is a showroom, (offsite, onsite), is there a significant finished goods inventory?

- If there is an offsite showroom, how is it staffed? Are the workers employees or independent contractors?

Are inventories of supplies maintained?

Where are inventories stored (warehouse, on site, off site, back room, held by vendors, in transit, etc.)?

What kind of controls are used for pricing and verification?

If you use standard cost system, when are standards updated?

How do you arrive at your standard costs?

How do you account for difference between standard cost and actual cost and when?

What are the policies regarding obsolescence, and slow moving or returned items?

What adjustments are made to the ending inventory balance before posting to the books, or to the return?

How long after a job order is received before you begin work on it?

How long does the average job take from the time work begins until it is completed?

When do you consider a job complete?

When are the first costs applied to the job?

When do you consider WIP present?

How is WIP computed and by whom? What departments are included?

How do you allocate indirect cost? To by-product inventory?

Sales

How are your sales prices determined and by whom?

What data is used to determine prices?

Do you use pricing guides?

How are salespeople paid? Do they earn commission?

If so, how are commissions determined?

How long after delivery do you send sales invoice to customers?

How many days does it take to collect on a job after you bill?

Do you require any deposits from customers when orders are placed?

If so, how do you account for deposits?

In addition to your normal product sales, do you provide any services to customers, that is, storage, distribution?

Do you charge for these services?

If so, how do you account for the sales and expenses related to the services?

If so, how are prices determined and how are they booked?

Do you ever bill and hold shipments? If so, how do you account for these?

When is income recognized? When the product is shipped? When the customer is billed? When payment is received?

Do you sell warranties or maintenance contracts? When is income recognized from these services?

Are unusable items such as scrap paper or used film recycled? If so, how do you account for them?

Are any inventories or services ever exchanged or bartered?

How are sales generated? (Independent sales staff, in-house sales staff, market shows, showrooms, etc.)

Do you do direct sales, use a broker or a distributor or a combination thereof? Are sales limited to your state or do you sell nationwide or export? Do you sell by-products?

When are sales recognized? What kind of documentation is required to record the sale (that is, delivery receipt, bill of lading)?

Is full payment required before goods are delivered?

Are discounts a normal part of business? If so, what type of discounts are given? Are there any discounts automatically taken by certain preferred customers?

Purchases

Who orders supplies and at what point?

Who are your vendors? What items do you purchase from them?

Do you ever make purchases from foreign companies?

Do you purchase supplies/services from any related parties?

If so, how are purchase prices determined?

Do you ever use outside contract services?

If so, how often and for what type of service?

What is the time frame for receiving purchase invoices for these outside services?

Do you order supplies to be sent to outside contractors? If so, describe.

When do you pay purchase invoices?

Do you take advantage of discounts? If so, how often?

How do you account for discounts taken?

Do you ever receive rebates from vendors?

If so, how do you account for rebates earned?

Fixed Assets

Was any new machinery purchased during the year?

What funds were used to purchase the equipment?

How are you financing the equipment?

Who did you pay to set up your machinery? Your computer programs?

Who decides the depreciation method and class life?

Over what life do you depreciate you equipment (presses, computers, etc.)?

How do you maintain your equipment?

What type of repairs have you had on your equipment?

Have you had any refurbishing of equipment during the year audited?

Have you purchased any hardware/software or updated software during the year audited?

If so, how did you account for the purchase?

Did you obtain the service of an outside consultant for software/computer services (setting up programs/systems and providing training of your employee)?

If so, how did you account for the cost?

Design/Advertising Expense

What new products or designs have been introduced during the year under examination? Design costs as well as catalog costs for these items may require capitalization if useful life is greater than one year.

Environmental

How have you prepared for an environmental regulatory review?

Has the company been reviewed or penalized regarding hazardous waste?

How does the company dispose of waste and how often?

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Chapter 3

REQUIRED FILING CHECKS

INTRODUCTION

The term package audit has been renamed required filing checks. The required filing checks are described in IRM 4034. Although many of the required steps simply involve inspection of returns, you are encouraged to perform a few additional procedures. It is not unusual for these filing checks to produce the most tax dollars in a corporate audit, especially if employment taxes are involved. Other adjustments can flow from Form 1099 work, either through penalties or back-up withholding. Related return inspection often produces leads for follow-up, resulting in tax adjustments at either a shareholder, related partnership, or brother-sister corporate level.

Take the time to perform a thorough filing check. This MSSP guide suggests a few audit steps covering the areas of adjustment noted. If you have a question regarding other areas, review IRM 4034.

In all examinations, particular attention should be focused on the employment tax area. The main concern is whether the taxpayer has improperly classified employees as independent contractors. If an improper classification was made and the issue is not raised, a future examiner may be precluded from raising the issue with respect to the same class of workers.

A new IRM Employment Tax Examination Handbook has been issued to the field. The 20 factors as outlined in Exhibit 4640-1 are being presented in a different manner.

EMPLOYMENT TAX RECONCILIATION

In a standard payroll reconciliation, you reconcile the wages and employment taxes between the employment tax returns (940/941 and state returns) and the income tax return. Differences can arise when the wages per employment tax return are compared to the wages per income tax return. When differences do arise, an issue may be present.

When this reconciliation results in a difference, attempt to reconcile the difference. Reasons for a difference include, but are not limited to, the following:

1. Amounts booked as salaries and wages are paid out of a general disbursement account rather than going through a payroll account. For example, payments such as Christmas bonuses may get paid out of the general disbursements account rather than the payroll account and thus would not appear in the payroll journal.

2. Officer salaries are accrued through the shareholder loan account. In this case, as the amounts did not enter the payroll journal, the Form W-2 may be understated as it is generally based on the payroll journal. Carefully review the shareholder loan account for this type of entry. These amounts are wages. They may have been erroneously omitted from the wage amount shown on Form W-2. In that event, the shareholder probably failed to report the amounts on his or her income tax return, and an adjustment will have to be made with respect to his or her income tax. With respect to FICA and FUTA, it may be that the shareholder's wages have exceeded the wage base for FUTA and for the OASDI wage base for FICA. Note that the wage base on the HI portion of FICA was repealed beginning with calendar year 1994. Thus, the HI tax is payable on all wages beginning in 1994.

If, after examining the accounts for explanations of the difference, you are unable to complete the reconciliation, you should copy your workpapers. Give the copies to the taxpayer, along with a document request, requesting an explanation and appropriate documentation.

Refer to Exhibit 3-1 at the end of this chapter for an example of a reconciliation of employment tax returns to the income tax return.

EMPLOYEE VERSUS INDEPENDENT CONTRACTOR

The issue of employee versus independent contractor is based on the facts and circumstances of each case. During the initial interview, question the taxpayer regarding any payments made to workers as independent contractors. The tax return may not separately show outside labor as an expense. The taxpayer may have made payments to workers as independent contractors which have been deducted on the face of the return as wages, under cost of goods sold as cost of labor, or under other costs as temporary employees.

The following is a brief outline of the law regarding employment status and employment tax relief. It is important to note that either worker classification--independent contractor or employee--can be a valid and appropriate business choice. For an in-depth discussion, see the training materials on determining employment status. "Independent Contractor or Employee?" Training 3320-102 (Rev. 10-96) TPDS 84238I. The training materials are also available from the IRS Home Page (http://www.irs.ustreas.gov).

The first step in any case involving worker classification is to consider section 530. Section 530 of the Revenue Act of 1978 was enacted by Congress to provide relief to certain taxpayers who had acted in good faith in classifying their workers from the potentially harsh retroactive tax liabilities resulting from IRS reclassification of independent contractors as employees. The statute is a relief provision and provides an alternative method by which to avoid employment tax liability where a taxpayer cannot establish his workers are or were independent contractors.

In order to qualify for section 530 relief, the business must meet consistency and reasonable basis tests. The consistency test requires that the business has filed all required Forms 1099 with respect to the worker for the period, on a basis consistent with treatment of the worker as not being an employee (reporting consistency); and that the business has treated all workers in similar positions the same (substantive consistency).

Under the reasonable basis test, the business must have had some reasonable basis for not treating the worker as an employee. There are three "safe harbors" that form the basis for an objective reasonable basis standard under section 530. These safe harbors are: (1) judicial precedent, published rulings, technical advice to the taxpayer or a letter ruling to the taxpayer; (2) a past favorable IRS audit on the same issue; and (3) long-standing, recognized practice of a significant segment of the industry in which the individual was engaged. A business that fails to meet any of these three safe havens may still be entitled to relief if it can demonstrate that it relied on some other reasonable basis for not treating a worker as an employee.

Before or at the beginning of any audit inquiry relating to employment status, an agent must provide the taxpayer with a written notice of the provisions of section 530. If the requirements of section 530 are met, a business may be entitled to relief from federal employment tax obligations. Section 530 terminates the business's, not the worker's employment tax liability and any interest or penalties attributable to the liability for employment taxes.

In general, the common law rules are applied in determining the employer-employee relationship. Internal Revenue Code section 3121 (d) (2). *Nationwide Mutual Insurance Co. V. Darden*, 503 U.S. 318 (1992).

Guides for determining a worker's employment 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 federal income tax withholding, respectively.

The regulations provide that, generally, the relationship of employer and employee exists when the person for whom the services are performed has the right to control and direct the individual who performs the services not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. The examiner will need to weigh the facts and circumstances of each case and determine worker status accordingly.

The training materials provide more information on the method of analysis used in determining employment status. They explain the kinds of facts to be considered, including those evidencing behavioral control, those evidencing financial control, and those evidencing the relationship of the parties.

For further assistance regarding employment tax issues, contact the employment tax coordinator.

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

OTHER EMPLOYMENT TAX ISSUES -- IN GENERAL

The discussion below addresses issues noted during the examinations of manufacturing returns in various industries.

1. Has the taxpayer included all compensation in the payroll computations and on the non-shareholder employees' Forms W-2?

   In several cases, the taxpayers had failed to include bonuses and fringe benefits, such as auto allowances in the non-shareholder employees' wages.

2. Has the taxpayer issued both a Form W-2 and a Form 1099 to the same employee? Compare the Forms W-2 and Forms 1099 to see if this has occurred. In several cases, the taxpayer issued a Form 1099 for bonuses and did not include the amount as compensation on the employment tax returns. **Note:** The employer may be entitled to relief under IRC section 3402(d) for the withholding if the employees had reported the Form 1099 income and paid the appropriate taxes.

3. Does the taxpayer use an outside payroll service? Usage of a payroll service may tempt you into thinking there are no problems associated with a taxpayer's payroll. This is not the case since the payroll service only follows through on the information provided by the taxpayer. If the information is incorrect, the reports issued by the payroll service will be incorrect.

4. In the case of an S-Corporation taxpayer, has a shareholder-employee been paid a salary? In some cases, an S-Corporation may report compensation as a distribution rather than as a wage or salary in an attempt to avoid employment taxes for both the corporation and the shareholder. Rev. Rul. 74-44, 1974-1 C.B. 287, was issued to direct a reclassification of a distribution to reasonable compensation and assert the related employment taxes.

Example 1

Assume an S-Corporation has a 100 percent shareholder who is also an employee and is single. The S-Corporation had ordinary income of $400,000 which flows through to the shareholder's individual return. The S-Corporation makes a cash distribution in the amount of $300,000 in lieu of salary. Of this $300,000, $200,000 has been determined to be a reasonable salary for the shareholder-employee with the remaining $100,000 accepted as a distribution. **Note:** The income tax computations below take into account only the amount of tax related to the income from the S-Corporation without itemized deductions, exemptions, etc.

If this were a December 31, 1993, tax return, the S-Corporation and its shareholder avoided the following employment taxes:

a.	Employer's portion of OASDI:	6.2%	of	$ 57,600	or	$ 3,571.20
b.	Employer's portion of Medicare:	1.45%	of	135,000	or	1,957.50
c.	Employer's FUTA:	6.2%	of	7,000	or	434.00
d.	Employee's portion of OASDI:	6.2%	of	57,000	or	3,571.20
e.	Employee's portion of Medicare:	1.45%	of	135,000	or	1,957.50
f.	Total employment taxes avoided:					$ 11,491.40

If the $300,000 were handled as a distribution solely or as salary and a partial distribution, the income tax would be as follows:

a. Distribution of $300,000. As was originally reported, the corporation had a flow through of ordinary income to the shareholder of $400,000.

   The shareholder would then pay income tax of $139,172 on $400,000 of ordinary income.

b. Reclassification of the $300,000 distribution to salary of $200,000 and distribution of $100,000. The corporation would then have $200,000 of adjusted ordinary income due to the $200,000 salary deduction.

   The shareholder would pay income tax of $139,172 on $400,000 made up of $200,000 of adjusted ordinary income and $200,000 in wages.

   There is no difference in income tax to the shareholder, but the corporation and shareholder avoided employment taxes in the amount of $11,491.40.

5. Garment and Non-Union Workers. Examinations of garment manufacturers and contractors involved numerous employment tax issues and generated large dollar adjustments. Due to space limitations, this guide cannot present a detailed discussion of those issues.

   Refer to the following audit techniques guides for an in depth discussion of these areas:

   a. Garment Manufacturers (4/97)
   b. Garment Contractors (6/97).

INTEREST FREE ADJUSTMENTS

The instructions for interest free adjustment for FICA and FIT taxes in certain situations has been revised in the new employment tax examination handbook. The new instructions clarify the interest-free adjustment period. If an adjustment is reported on a supplemental return (or signed Form 2504) but the amount is not paid, interest accrues thereafter from the first day following the due date of the ascertainment period return. Also, the instruction contained in IRM 4641.1(2) does not state that the taxpayer must make full payment of the FICA and FIT taxes and penalties owed at the time of signing the Form 2504 agreement before granting the interest-free adjustment.

If the interest free adjustment applies, make the following notation on Form 3198. Under special handling/processing instructions, check the box noted "Restricted Interest Case" and enter "Form 2285 not required, IRC 6205(a)." See IRM 4677 for additional information.

INFORMATION RETURNS

The examination of information returns can be an important part of any income tax examination. Failure to issue information returns or failure to include correct information may lead to various issues such as information return penalties, backup withholding and unreported income.

There are numerous types of information returns a taxpayer may be required to file. The discussion below is limited to Forms 1099 encountered during manufacturing examinations. Therefore, this section should not be considered a complete discussion of the filing requirements for all information returns one may encounter during an audit.

FORM 1099

The Forms 1099 encountered include 1099 MISC for payments of non-employee compensation, rents, and royalties and 1099 INT for payments of interest.

Examination Techniques

Initial Review of Return

While reviewing the tax return, note expenses on the return that may indicate a requirement to issue a Form 1099. For example, interest expense may indicate a 1099 INT filing requirement, while commission expense may indicate a 1099 MISC filing requirement.

Initial IDR

The initial IDR should request all Forms 1099 issued along with the Form 1096, Annual Summary and Transmittal of U.S. Information Returns, filed for the calendar year(s) encompassed by the tax year under examination. For example, if the taxpayer's yearend is 9306, request the Forms 1099 and Forms 1096 for calendar years 1992 and 1993. If the taxpayer files information returns on magnetic media, the transmittal document is Form 4804.

Reconcile the total number of Forms 1099 presented by the taxpayer to the number of forms issued per the Form 1096. For example, the taxpayer gives you 20 Forms 1099 and the Form 1096 indicates that 15 were filed.

If a discrepancy is noted or if the Form 1096 is not provided, request a PMFOL from the group secretary. The PMFOL will give a summary of the information returns per the Form 1096 filed with the IRS. The PMFOL provides information from the Payer Master File in an on-line report. If additional information is required, request a listing of Forms 1099 filed by the payer with the IDRS command code IRPTR-R.

Forms W-9

The initial IDR should also include a request for any Forms W-9 secured from independent contractors. The Forms W-9 are used to test the accuracy and completeness of the Forms 1099 issued. A comparison should be made between the Forms W-9 and the Forms 1099.

The Form 1099 must include both the payer's and payee's complete name, address, and Federal TIN. A sole proprietor must furnish his or her individual name and either the Social Security Number or Employer Identification Number. See Treas. Reg. section 35a.3406-1.

If the Form 1099 contains incorrect information because the taxpayer relied upon the information provided on the Form W-9, it is generally accepted that the taxpayer has complied to the best of his or her ability. If, however, the taxpayer has not used the TIN provided by the payee, consider asserting a penalty for filing an incorrect or incomplete Form 1099 with possible intentional disregard of the rules.

If the taxpayer failed to obtain the payee's TIN, consider the application of backup withholding. See the Backup Withholding section of this chapter for further information.

Compare Forms 1099 to Forms W-2

Compare the Forms W-2 and Forms 1099 issued. If there are individuals who were issued both a Form W-2 and a Form 1099, refer to the employment tax section of this guide.

Verify Filed Forms 1099

The initial IDR should also request the taxpayer's schedules used to prepare the Forms 1099. Reconcile the amounts on the Forms 1099 to the taxpayer's schedule. If the taxpayer does not have a schedule, you may need to schedule out payments to test the dollar accuracy.

Select one or two Forms 1099 with the largest dollar amounts. Reconcile the amounts on the taxpayer's schedule with the cash disbursements journal and canceled checks. Compare the canceled checks with the cash disbursements journal. Examine the canceled checks for any unusual endorsements. Question discrepancies. If any discrepancies are not adequately explained, expand the examination to additional Forms 1099.

Scan Canceled Checks

Scan the taxpayer's canceled checks for the following:

1. Any differences between the payee on the canceled check and the disbursements journal.

   Note: The name per the cash disbursements journal and the Form 1099 may not match. Checks may be issued to a business under the dba and the Form 1099 issued in the legal name.

2. Any unusual payees which do not correlate with the taxpayer's business.
3. Endorsements which are different than the payees name on the face of the check.

4. Checks cashed at grocery stores or check cashing places.

5. Hand written endorsements or non-corporate entities.

If checks are found with these conditions, write down as much information as possible such as check number, date, payees name, vendor number if present, dollar amount, and the bank account number used with the endorsement. Trace the questionable checks back to the general ledger account and the taxpayers retained copies of Forms W-2 and Forms 1099.

If vendor reports are available, request them for the individuals in question. This may save time by listing all pertinent checks. If unable to obtain a vendor report, decide whether to expand the scope to include additional months or accept the months scanned. Sometimes it is possible to pinpoint the general ledger account to which the questionable payments are being booked. However, many times the payments may be spread among many different accounts.

Nonfiled Forms 1099

Scan the cash disbursements journal and accounts payable journal for payments to individuals of $600 or more for which a Form 1099 was not issued. In addition, while scanning the canceled checks, be alert for potential non-filed Forms 1099. The taxpayer should be questioned as to the reasons why a Form 1099 was not filed.

If the taxpayer failed to file or furnish Forms 1099, consider the assertion of the penalties discussed below and the backup withholding provisions discussed in this guide.

By performing these steps, you may find possible employment tax issues. The employment tax issue may either be possible payments made to employees which did not get reported on a Form W-2, 940, or 941 or for payments made to independent contractors not reported on a Form 1099. In addition, there may be a problem with the amounts reported on Forms 1099 filed.

For additional information on how to handle additional payments paid which were not reported on the information return or for payments not reported on any information return, see the section on employment taxes and backup withholding.

Information Returns Statute of Limitations

Penalties with regard to information returns (IRC section 6721 and IRC section 6722) may have statute of limitations considerations governed by IRC section 6501. If a taxpayer is penalized only for not having filed or furnished an information return, you need not be concerned with a statute of limitations because in the case of no return having been filed, the statute of limitations has not started to "run" (IRC section 6501(c)(3)).

However, if the penalty is for filing or furnishing an inaccurate/incomplete information return, the normal 3 year statute of limitations started running from the time the return was filed/furnished.

BACKUP WITHHOLDING

One of the major compliance tools to consider in the event Form 1099 statements were not filed when required or were filed but did not have a payee TIN is the backup withholding provisions of IRC section 3406. Backup withholding can be imposed in conjunction with the penalties under IRC section 6721 and IRC section 6722.

If an individual is subject to backup withholding and amounts are not withheld, the payer becomes responsible and liable for the tax. For reportable payments made prior to January 1, 1994, the rate was 20 percent. After December 31, 1993, the rate increased to 31 percent. As this rate is applied to the withholding amount paid, assessments can be substantial. The assessment can be abated if the tax on the income was paid by the payee.

A payment is subject to backup withholding if the payment is subject to information reporting as set forth by IRC section 6041(a). For example, a payment for compensation to a non-employee from a trade or business aggregating $600 or more for one calendar year is a reportable payment.

Application of IRC section 3406 to information returns required under IRC section 6041 involves two primary criteria. In the case of any reportable payment:

1. The payee fails to furnish his or her TIN to the payer in the manner required

2. The Secretary notifies the payer the TIN furnished by the payee is incorrect. Then the payer shall deduct and withhold from such payment a tax equal to 20 percent (or 31 percent) of such payment.

The first step in determining whether backup withholding provisions are applicable lies in the required filing checks. All Forms 1099 should be secured as outlined under the Form 1099 section of this guide. Backup withholding may apply in the following situations:

1. A required Form 1099 was not filed, the TIN was not obtained, and backup withholding was not deducted and deposited from the payment.

2. The TIN was not obtained, backup withholding was not deducted and deposited, but a Form 1099 statement was filed.

3. Forms 1099 were filed with incorrect TINs and backup withholding was not deducted and deposited after notices were sent to the payees that the TIN furnished was incorrect.

To determine whether any of the above situations have occurred, ask the taxpayer what steps were taken to obtain a payee's TIN and what was the response regarding any such requests. Even though the taxpayer may not be subject to backup withholding, they may still be subject to the previously discussed information return penalties.

Note: If the taxpayer has filed a Form 1099 with a correct TIN, backup withholding would not be applicable even if the dollar amount of the Form 1099 is incorrect. In this situation, look to the information return penalties in lieu of the backup withholding provisions.

Assertion Procedures

Backup withholding is treated as an employment tax. As with all employment taxes, the agreement report is Form 2504.

The report forms to be completed are Form 4666 and Form 4668. With respect to the Form 4668, Employment Tax Examination Changes Report, you must change item 4 to read as follows: "Payment subject to backup withholding IRC section 3406."

Establish the proper return on AIMS as follows:

1. For periods prior to the first quarter of 1994, backup withholding under IRC section 3406 is reported on Form 941, Employer's Quarterly Federal Tax Return, for the applicable quarters of payment similar to employment taxes. However, in some cases, it may be reported in the last quarter of the calendar year.

2. Beginning with the first quarter of 1994, backup withholding is reported on Form 945, Annual Return of Withheld Federal Income Tax. The Form 945 is an annual return and is due by January 31 of the subsequent year. As this is a new form, the procedures for assessment for backup withholding are assumed to be as noted. It is unclear at this point as to the procedure to follow if the taxpayer has not filed the Form 945. If you run into this issue, contact the employment tax coordinator for the proper procedures.

Abatement Procedures

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

The revised employment tax examination procedures will not require the taxpayer to submit a copy of the recipients income tax return as proof. The taxpayer may submit Form 4669, Employee Wage Statement, signed by the recipient, or you can verify the filing through IRS internal records (FTVUE).

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

Under the revised procedures, you are allowed to accept and abate income tax withholding taxes under IRC section 3402(d) before the case is closed from the group.

RELATED RETURNS

Keep in mind the inspection of related returns is required by the IRM. Do not forget the examination is of the taxpayer as a whole, not just one segment of the whole picture. By following this, you are reviewing the financial status of the taxpayer and all his or her related entities. You should then be able to determine whether the taxpayer has reported a realistic taxable income.

During industry examinations, many issues arise with respect to related entities. In some cases, the issues on the related returns result in larger deficiencies than the key case examination.

Identifying Related Returns

During the initial interview, question the taxpayer as to the existence of related returns. It is important these questions be specific enough so the taxpayer understands the question and you receive the information for which you are looking.

If the taxpayer is a corporation or partnership, some questions which should be asked include the following:

1. Is the taxpayer a shareholder in any other corporations or partner in any other partnerships? Does the company do business with these corporations or partnerships?

2. Do the shareholders or partners own stock in any other corporations or are they partners in any other partnerships? Is business conducted with these related corporations or partnerships?

3. Do any close family members own stock in any corporations or are partners in any partnerships? Does the company do business with these related corporations or partnerships?

In addition to the initial interview questions, review the chart of accounts for titles which indicate a related party -- for example, Loan to Affiliate.

Review the endorsements of either all the canceled checks or a sample of canceled checks for the tax year. Are any of the checks made out to companies and endorsed by known related parties? **Note:** This check can be done in conjunction with the Form 1099 check discussed in the information returns section of this chapter.

Closely inspect the Schedule E and related schedules of the shareholders' and partners' returns. These often show investments in related companies.

Corporate Taxpayer -- Shareholder Issues

The inspection of related returns includes those of the shareholders of the corporation. Compare the returns to see that related transactions are properly reported on both returns.

Many of the issues involved with a corporate shareholder relate to the shareholder loan accounts on the balance sheet.

Loans to/from Shareholders

During the initial interview, inquire as to the existence of loans and the taxpayer's policies with respect to the loan, repayments, interest rates, and collateral. Review the corporate balance sheet for the existence of loan accounts either to or from the shareholder. However, no entry on the balance sheet for shareholder loan accounts does not mean there are no outstanding loan balances. In several cases, it was noted the shareholder loans were included in asset and liability accounts other than the normal loans to/from shareholder account.

Once the existence of a shareholder loan is established, the concern is whether the loans are arms length transactions (that is, length of loan, interest rate, etc.). The shareholder could be receiving an interest free loan. They may be taking money out of the company tax free through forgiveness of the loans by the corporation at a later date.

Request copies of the loan documents. If loan documents exist, they will show the terms which you can then validate. If loan documents are not available, review the corporate minutes for a possible mention of and the details of the loans.

Interest Generated by a Loan From Shareholder

In regards to interest generated by a loan from shareholder, inspect the payables accounts for a possible write-off of the interest owed the shareholder which has not been paid.

IRC section 267(a)(2) states the corporation and the shareholder (who must hold a greater than 50 percent interest in the company either directly or by attribution) will be put on the same basis of accounting, usually cash basis, to determine when a write-off is allowed, even though one is an accrual basis and the other is cash basis. In simpler terms, the corporation will be allowed a deduction when the interest is paid, not when it is accrued. If the corporation has accrued the expense, inspect the Schedule M-1 to determine whether the amount has been backed out for tax purposes.

Example 2

During the audit of a corporate taxpayer with a tax year 9206, the agent noticed the corporation had deducted $125,000 as interest expense which was related to a shareholder loan. Upon further review, it was found the corporation had only paid $75,000 with the other $50,000 being an accrual. This accrual of $50,000 was finally paid prior to the end of the 1992 year. Even though the shareholder was required to include the full $125,000 in his 9212 year, the corporation was not allowed a deduction for the accrual of $50,000 in the 9206 year, but instead was allowed it in their 9306 year.

Demand Loans

1. Often, the loans between the taxpayer and its shareholder will be demand loans in lieu of formal loans with a stated rate of interest and repayment period.

   In the case of demand loans, special rules apply. Under IRC section 7872 the foregone interest on such below market interest rate loans is treated as transferred from the lender to the borrower as of the last day of the calendar year and re-transferred immediately from the borrower to the lender as interest. There is a $10,000 de minimis exception for compensation related and corporate-shareholder loans that do not have tax avoidance as one of the principal purposes (IRC section 7872(c)(3)).

2. When a corporation makes interest free (or low interest) loans to its shareholders, the shareholders' family members, or other related parties as discussed in IRC section 318(a), the following actions are deemed to have occurred:

   a. The shareholder has received a constructive dividend in the amount of the foregone interest to the extent of earnings and profits.

   b. The corporation receives a like amount of interest income.

   c. After the 1990 year, the shareholder will only be allowed a deduction for the interest deemed paid to the corporation if they can demonstrate the expense is investment related.

3. When a below market interest rate loan is made between otherwise related entities, or a share holder makes a loan to his corporation, the adjustments resulting after imputing the interest are:

   a. The shareholder receives interest income in the amount of the foregone interest.

   b. The corporation has deemed interest expense in a like amount.

   c. The foregone interest will be treated as a capital contribution by the shareholder (Treas. Reg. section 1.7872-4(d)).

4. Although the transfer of taxable income between entities may appear to be offsetting, there can be significant tax impact in the reallocation, depending on the relative tax brackets of the borrower and lender and the deductibility of the interest deemed paid.

Consult the regulations for detailed instructions for computing the interest imputed on interest free and below market rate loans using published Federal rates.

A simplified method is available for use in imputing interest on loans of $250,000 or less. If loans exceed this amount, a business or financial calculator capable of raising "x" to the "y" power is required.

Despite the fact the computation may seem somewhat tedious at first, adjustments can be substantial and are easily sustained.

Capital Stock/Capital Account

In manufacturing companies which have been around for a few generations, a reconciliation of the ownership account through the stock certificates/stock book is usually necessary. This reconciliation should be compared to the Schedule E or an ownership schedule attached to the return. Ask questions if the ownership does not reconcile to the return. Reconcile the stock ownership early on during the audit so any adjustments for personal usage of corporate assets or distributions of corporate assets can be proposed to the correct individual.

The reconciliation of the ownership account is very important in a TEFRA and non-TEFRA S-Corporation or partnership examination because of the nature of these entities. Any adjustments proposed at the entity level will in most cases have a direct tax effect at either the shareholder or partner level.

Example 3

An S-Corporation with three shareholders had allocated 100 percent of the losses to the 80 percent shareholder and none to the other two shareholders. The examiner proposed adjustments at the shareholder level to correct this allocation. From the initial interview, the examiner knew the two shareholders were passive investors. Therefore their losses were limited because of the passive activity rules under IRC section 469. A minor change in the K-1 reporting resulted in a substantial adjustment.

Because many of the companies are fairly old, the older shareholders will either gift their stock to the younger shareholders (usually family members) or sell the stock back to the company. Each transaction can have a tax consequence either through a gift tax or a capital gain under IRC section 1221. In addition, if a shareholder's stock is redeemed as treasury stock, IRC section 306 will govern the ex-shareholder's actions with the company for up to 10 years after the sale. If the ex-shareholder fails to comply with IRC section 306, the redemption could be classified as a dividend distribution. If any of these issues are found, further research is necessary.

Other Related Return Issues

Pay particular attention to all transactions between related parties as well as the isolated transactions of the related party. Specific types of issues encountered are discussed below.

1. Transactions Between Related Parties

   Determine whether any transactions between related parties are occurring and, if so, the nature of these transactions. Transactions may take many forms such as consulting agreements, leasing agreements, expense sharing agreements, and so on. Scrutinize these transactions and if possible, compare them with transactions held with other independent third parties. Valuation referrals may need to be made to determine fair rental or market value.

   Example 4

   The primary corporate taxpayer was found to have engaged in business with a related corporation. The corporation was related by common shareholders. The transactions were analyzed from both sides. It was determined the transactions were made primarily for tax avoidance. Before the transaction, the primary corporation had a large taxable income while the related corporation had a loss. The primary corporation wrote out a check for a substantial amount of money to the related corporation and deducted it as a consulting fee. The related corporation picked up the money as income. This transaction resulted in the primary corporation reducing its taxable income while the related corporation still paid no tax.

2. Rental Transactions Between Corporation and Related Parties

   The initial interview should contain questions regarding the leasing of property from any related parties. Many of the items discussed below occurred between the shareholder and the corporation. However, these transactions may occur between non-shareholder related parties also. In many corporate examinations in which the companies have been in business for many years, the shareholders owned the business property. In this situation, the shareholders often pay themselves higher lease amounts in lieu of salary subject to employment taxes.

   a. Examination Techniques

      1) Review Lease Agreements

         Review the lease agreements for the types of property being leased. Lease agreements show the lease terms, deposit requirements, any lease acquisition fees, rental base and charges, including provisions for cost of living increases. Once the rental agreements have been reviewed, the total

deductible rent for the year may be easily computed using the amounts provided for in the lease agreements.

If you compute a rental cost substantially less than that deducted on the return, this may lead to additional rental property for which you were not provided a copy of the lease agreement. Possibilities for holding back lease agreements include rental arrangements between related parties which do not reflect true fair rental values or payments made by the corporate or partnership entity on behalf of a shareholder or partner.

2) Analyze Lease Agreements

When analyzing the lease agreements, take into account the reasonableness of the charges. Be watchful for rentals between related parties. Pay close attention to the amounts charged to determine whether a fair rental value is being paid. In general, it is assumed that if the taxpayer is leasing property from an unrelated third party the rental charges are at fair rental value. If the amount charged seems unreasonable to you, carefully review leases charged by apparent third parties. Possibilities include lease arrangements between a corporation and a shareholder's family member with a different surname.

Check with real estate brokers in the area of the property. The real estate offices can give you an idea of the fair rental values in the area.

If further examination work is warranted and the dollar amount significant, you should, with your manager's approval, make a referral to the Engineering Division to determine if there is an issue. If this step is warranted, make the referral as early as possible in order to give the Engineering Division time to complete its work while the remainder of the exam is in process. The engineering referral is made on Form 5202 and the procedures are outlined in IRM 42(16)2.

3) Timing of Deduction

In addition to the question of fair rental value, there is another issue to be considered when there is a rental of property between related parties as defined in IRC section 267(b). IRC section 267(a)(2) provides that a deduction is allowable to an accrual basis taxpayer in the year in which the income is includible by the related party.

Example 5

A corporation whose yearend is December 31, 1991, pays its shareholders $200,000 during the year for rent. In addition, it also accrues another $200,000 of rent expense to the same shareholder at yearend. The 100 percent shareholder has filed his 1991 Form 1040 return and has reported $100,000 on his Schedule E. The examiner has two separate issues:

1. The corporation is only allowed to deduct the amount of rent which is includible in the shareholder's income at the time of the transaction. In this case, since the cash payment of $200,000 was made to the cash basis shareholder and was required to be included in his income, the $200,000 accrual at year end is disallowed for corporate year 9112.

2. The examiner has a $100,000 unreported income issue on the shareholder's return. The corporation still gets the full $200,000 deduction since that was the actual payment made to the shareholder.

3. Rental Payments for Personal Use

   If lease liabilities are not included on the balance sheet, examination of the disbursements may reveal payments for equipment leased for the benefit of the shareholders.

4. Are Shared Costs Being Properly Allocated Between Two Or More Entities?

   One examiner encountered the situation in which the 100-percent owner of a C-Corporation was also the 100-percent owner of an S-Corporation, both of which were furniture manufacturers. The two corporations operated out of the same business location, with the C-Corporation paying all the operating expenses. At yearend, an allocation was made between the two. The S-Corporation reimbursed the C-Corporation for its portion. During the examination it was determined expenses related strictly to the S-Corporation were allocated to the C-Corporation. This resulted in a reduction of the taxable income of the C-Corporation which would have been taxed at a higher rate than the S-Corporation flow through to the owner's return. An adjustment was made to properly allocate the expenses between the two entities.

5. Keep in mind there may be potential issues on shareholder returns unrelated to the corporation.

6. Commissions paid to the related parties in a closely-held corporation on sales generated should be scrutinized carefully.

In one case, a corporation was paying the shareholder a 30-percent commission on generated gross sales while the independent sales staff were being paid between 4

percent and 7 percent. This was a method of drawing a dividend out of the corporation while still taking a deduction at the corporate level.

FOREIGN ENTITIES

Pay particular attention to any related entities which are outside the United States. When a manufacturer is dealing on a regular basis with a foreign related company, make a referral to an International Group using Form 2962.

If the taxpayer under examination owns a foreign corporation, the taxpayer may be required to file Form 5471 (Information Return with Respect to a Foreign Corporation) with the return. This is a disclosure form and is to be filed by all parties who own a foreign corporation. When a Form 5471 is attached to a return, this is an indication to the examiner a referral will be necessary. However, some taxpayers fail to file a Form 5471. Question any transactions with a foreign entity to determine if there is a possible ownership issue.

EMPLOYMENT TAX RECONCILIATION

The simplest reconciliation is performed when an accrual basis taxpayer's fiscal yearend coincides with an employment tax return quarter end. This is demonstrated in an example below.

Often the taxpayer's fiscal yearend will not coincide with a quarterly end date. For example, a taxpayer has a fiscal yearend of July 31, 1992. The employment tax returns encompassing the income tax year would then be September 30, 1991; December 31, 1991; March 31, 1992; June 30, 1992; and September 30, 1992. Take the following steps to gather the information required for the reconciliation:

1. Starting at the beginning of the fiscal year, schedule the salaries, wages, and payroll tax expense accounts per the payroll journal. Schedule the amounts paid from the beginning of the fiscal year to the nearest quarter end. In the example above, this includes the months of August 1991 and September 1991.

2. Extract the wages/salaries and taxes from the employment tax returns for the next three quarters.

3. At the beginning of the final quarter, schedule the salaries, wages, and payroll tax expense accounts per the payroll journal. Schedule the amounts paid from the beginning of the quarter to the end of the fiscal year. In the example above, this includes the month of July 1992.

4. The amounts obtained above can then be reconciled using a reconciliation similar to that shown in the example below in order to determine whether there are any differences between the employment tax returns and the income tax return.

Note: Prior to January 1, 1991, the FICA tax was a combined rate for both old-age, survivors, and disability insurance (OASDI) and hospital insurance (Medicare). The combined rate was applied against the employees wage up to the applicable wage limitation for each calendar year. Beginning January 1, 1991, the OASDI and Medicare rates are applied against different wage limitations for each calendar year.

The taxpayer, Oak Corporation, is under examination for the fiscal year ended June 30, 1991.

Per the face of the Form 1120 and Schedule A Cost of Goods Sold:

Officer's Compensation	$ 1,763,830.00
Salaries and Wages	445,895.00
Payroll Taxes	48,333.00
Sch A Cost of Labor	959,180.00
Sch A Indirect Labor	285,146.00
Sch A Payroll Taxes	109,862.00

Per the taxpayer's General Ledger:

Accrued Payroll @ 7/01/90	$ 479,218.15
Accrued Payroll @ 6/30/91	1,645,285.48
Accrued Payroll Taxes @ 7/01/90	9,761.62
Accrued Payroll Taxes @ 6/30/91	19,552.62

Per the Employment Tax Returns:

Form 940 & 941	9/30/90	12/31/90	3/31/91	6/30/91
Total Wage	$ 734,919.38	$ 469,237.68	$ 398,043.02	$ 560,783.43
Withholding	102,586.00	43,299.43	34,031.56	54,631.40
FICA Wages	381,842.42	398,958.85	398,043.02	495,660.47
Medicare Wages	N/A	N/A	398,043.02	560,783.43
FICA Tax	58,421.89	61,040.71	49,357.3	61,461.90
Medicare Tax	N/A	N/A	11,543.25	16,262.72
FUTA Wages		652,631.25		
FUTA Tax		5,221.05		
State Income Tax	1,578.25	1,431.67	5,631.51	4,685.83
State Training Tax	87.68	79.54	351.97	292.86

Reconciliation of the above amounts and associated examination adjustments are shown below.

TAXPAYER:	Oak Corporation	AGENT:	I.R.Agent
FORM NO:	1120	DATE:	08-01-93
YEAR:	9106		

RECONCILIATION OF SALARIES AND PAYROLL TAXES TO RETURN

INFORMATION FROM FORMS 941 AND STATE TAX FORMS:

Quarter Ended	Total Wages	Withholding Tax	FICA Tax	Medicare Tax	State Tax
09/30/90	734,919	102,586	58,422	)))))	1,666
12/31/90	469,238	43,299	61,041	)))))	1,511
03/31/91	398,043	34,032	49,357	11,543	5,983
06/30/91	560,783	54,631	61,462	16,263	4,979
TOTAL	2,162,983	234,548	230,282	27,806	14,139
	=========	=======	=======	=====	======

FUTA RETURN INFORMATION:

Year 12/31/90

FUTA Taxable Wages	652,631
Times Rate	0.008
Gross Federal Tax	5,221
Less State Credit	(0)
Net Federal Tax	5,221
	4444444

RECONCILIATION OF WAGES:

Wages - Cost of Sales	959,180
Indirect Wages - Cost of Sales	285,146
Salaries - Officers Compensation	1,763,830
Salaries and Wages	445,895
Total Salaries per Return	3,454,051
Salaries per 941'S	2,162,984
Less: Accrued Payroll Beginning	(479,218)
Plus: Accrued Payroll Ending	1,645,285
Total per Books	3,329,051
Wage Difference	125,000
	=========

RECONCILIATION OF PAYROLL TAXES:

Payroll Taxes	48,333
Payroll Taxes-SCH A	109,862
Total Payroll Taxes per Return	158,195
Employer FICA Tax (230,282 x 1/2)	115,141
Employer Medicare Tax (27,806 x 1/2)	13,903
Employer State Tax	14,139
Net FUTA Tax	5,221
Less: Accrued Payroll Taxes Beginning	(9,762)
Plus: Accrued Payroll Taxes Ending	19,553
Total per Books	158,195
Payroll Taxes Difference	0
	=======

In this example, Oak Corporation has deducted $125,000 in wages on the income tax return which do not appear on the employment tax returns. Upon further investigation, the examiner determined the following:

1. Per the general ledger, Officers' Compensation, Account Number 5010, included the following entries:

Date	Reference	Amount
7/31/90	Payroll Jnl	$ 170,500
8/31/90	Payroll Jnl	120,200
9/30/90	Payroll Jnl	170,500
10/31/90	Payroll Jnl	100,170
11/30/90	Payroll Jnl	170,500
12/31/90	Payroll Jnl	105,260
1/31/91	Payroll Jnl	170,500
2/28/91	Payroll Jnl	120,200
3/31/91	Payroll Jnl	170,500
4/30/91	Payroll Jnl	110,000
5/31/91	Payroll Jnl	170,500
6/30/91	Payroll Jnl	110,000
6/30/91	C/D Journal	75,000
Ending Balance		$1,763,830

2. Per the general ledger, the cost of sales wages is a total of the following accounts:

	Account	Amount
A/C	#5010 Wages - Cutting & Sewing	$ 294,720
	#5020 Wages - Factory Wood	255,830
	#5030 Wages - Finishing	358,630
	#5040 Wages - Temporary Help	50,000
	Total	$ 959,180

3. The examiner questioned the taxpayer's CFO and discovered the following:

   a. The $75,000 debited to Officers' Compensation represented a bonus paid to the corporate president, Mr. Able. The bonus was not included in the reports submitted to the payroll service and this amount was not included in Mr. Able's 1991 Form W-2. Inspection of the Form W-2 revealed his wages exceeded the withholding limitations for all payroll taxes. Review of Mr. Able's Form 1040 for 1991 revealed that he reported only those wages shown on his Form W-2.

   b. During periods of peak production, the taxpayer hires additional workers for the various departments. The taxpayer mistakenly failed to treat these workers as employees. Their wages are paid directly from the C/D Journal and are not included in the payroll reports submitted to the payroll service. The taxpayer does not withhold payroll taxes from these wages.

   Based on the information gathered by the examiner, the following adjustments were proposed and agreed to by both the corporation and Mr. Able:

   1) Oak Corporation's employment tax returns were opened for examination and adjusted for additional taxes associated with the $50,000 in wages paid to the temporary workers.

   2) Mr. Able had additional income of $75,000 on his Form 1040.

Chapter 4

BALANCE SHEET

INTRODUCTION

The balance sheet is a very important component of the tax return for any Form 1120, 1120S, or 1065. An audit of a sole proprietor needs to be handled differently since no balance sheet is present on an individual tax return and financial statements may not have been prepared.

A balance sheet audit provides a good supplement to an income statement audit. By auditing the balance sheet, you may find accounts which the taxpayer has handled incorrectly for tax purposes (that is, allowance for doubtful accounts, cash discounts reserves). This is not to say these accounts could not have been found through an income statement audit. A journal entry in the income statement account could be traced back to these balance sheet accounts. On the other hand, if you had focused strictly on the income statement, you could miss these accounts entirely if there was no activity (no income statement write-off) for the year of audit.

Since balance sheet accounts are real accounts balances (yearend are carried forward), proposed adjustments can carry many years worth of accumulations. However, you must determine whether the questioned account constituted a method of accounting. Thus, you must determine that the questioned account involved the erroneous treatment of a material item. A material item is any item which involves the proper time for inclusion of the item in income or the taking of a deduction. See Treas. Reg. section 1.446-1(e). If the questioned account involves the erroneous treatment of a material item in the prior and current years, an adjustment may be warranted under IRC section 481 for the accumulation amount while the applicable Code section will be used for the current year adjustment (IRC section 166). However, if the taxpayer has made a Schedule M-1 adjustment taking into consideration the different treatment between financial (reserve method) and tax accounting (direct write-off method), no adjustment is necessary because the taxpayer has not written it off for tax purposes.

The following example uses both scenarios discussed above.

Example 1

A tax return balance sheet contains an account called Reserve for Sales Discounts. The balance at the beginning of the audit year was $50,000 and $75,000 at the end of the year. The current year increase to the account was $25,000. Presently the examiner does not know whether there will be an immediate tax effect.

Scenario 1: Upon further investigation, the following is determined:

1. No Schedule M-1 adjustment for the $25,000 increase in the account was made.

2. Sales were reduced by the $25,000 increase in the reserve for sales discounts.

3. Taxpayer cannot explain why the adjustment was made.

4. Similar adjustments were made each year either increasing or decreasing the account with no corresponding Schedule M-1 adjustments.

Based on these facts the examiner would propose the following adjustments:

1. $25,000 current year adjustment for the increase in the reserve account under Treas. Reg. section 1.461-4(g)(3) because the reserve method is not allowed, in most cases, for tax purposes; and,

2. $50,000 adjustment for the accumulation under IRC section 481 because of the incorrect accounting method used in the prior years.

Scenario 2: Upon further investigation, the following is determined:

1. A Schedule M-1 adjustment was made for the $25,000 increase in the account during the year.

2. Examiner reviews the adjusting journal entry to convert book accounts to tax accounts andnotices this entry reverses the original entry which had previously reduced sales for the year.

3. Taxpayer has handled this account the same way each year.

Based on these facts, the examiner does not have an issue with the current increase in the account of $25,000 or the accumulation of $50,000 because the taxpayer has not received any tax benefit from these reserves in either the current or prior years.

INTERRELATIONSHIP BETWEEN BALANCE SHEET AND INCOME STATEMENT

As illustrated in Scenario 1 above, when adjustments are proposed to a balance sheet account, the effect will usually be to taxable income unless proven other wise. One exception to this rule would be a conversion of current year borrowings by the shareholder into a constructive dividend. (This is assuming the taxpayer has earnings and profits as defined in IRC section 312. See IRC section 301(c) to determine how

to handle a distribution if taxpayer has no earnings and profits.) The reason adjustments to a balance sheet account usually have an effect on the income statement is because both are interrelated. All income statement accounts run through the balance sheet. For example, a sale of merchandise would be booked as follows:

DR Accounts Receivable
CR Sales

When the accounts receivable are collected, the entry would be:

DR Cash
CR Accounts Receivable

However not all balance sheet accounts run through the income statement. In the previous example, the conversion of loans to shareholder into a constructive dividend, in all likelihood, was not expensed by the corporation thereby having no effect on the income statement. The entry to adjust these accounts and which should be proposed by the examiner is:

DR Retained Earnings
CR Loans to Shareholder

EFFECT OF BALANCE SHEET ADJUSTMENTS ON TAXABLE INCOME

At the end of the year, the income (sales) and expense accounts are closed out into retained earnings. The net result is either net income or net loss. If you find an unexplained increase in the cash account, it may be an indication of an income understatement. Based on this principle, an adjustment to a balance sheet account will usually have the following effect on taxable income (T.I.) unless proven otherwise:

Adjustments to Balance Sheet Accounts

	Increase	Decrease
Assets	+	-
Liabilities	-	+

+ = Increase T.I.
- = Decrease T.I.

You are reminded not every adjustment to the balance sheet has an effect on taxable income. This was illustrated previously in the conversion of loans to shareholders into a constructive dividend.

PRELIMINARY AUDIT STEPS

To gain an understanding of how the balance sheet is comprised, there are two steps which should be performed in all cases and with every account on the balance sheet.

Reconcile the Book Accounts to the Return

This is a very important step. There are two methods which can be used:

1. Schedule A reconciliation; or,

2. Line by line reconciliation, which will be discussed here.

By reconciling the book amounts, a better understanding of how the accounts are classified is gained. It also requires you to contemplate every account title which could create many questions (that is, accounts receivable reserve). The taxpayer may have one or several general ledger accounts per line item on the balance sheet. Either way, you should have a better understanding of the general ledger accounts and a feel for how the books work after the reconciliation.

One of the primary reasons for this reconciliation is to uncover potential problems thereby preventing future confusion. To illustrate, you discover the receivables per the tax return are less than the receivables per the books. You decide to propose an increase in the accounts receivable and, therefore, an increase in sales. You inform the accountant about this adjustment and its effect on taxable income. At this point the accountant says, "I knew about this adjustment before you started the audit, it was a classification error." The accountant pulls out his trial balance which shows the difference was in the Other Assets account.

An Accounts Receivable account was accidentally combined with the Other Assets account on the return, causing an overstatement in the Other Assets and an understatement in the Accounts Receivable. The difference between the Other Assets account on the return and the general ledger accounts for Other Assets is the difference for which he was ready to propose an adjustment. This could have been avoided if a line-by-line reconciliation had been performed since this would have highlighted the error in the Other Assets account.

Once the book accounts have been reconciled to the return, you will be auditing the books and not the return.

Comparative Analysis

The next step is to perform a comparison of the balance sheets of the prior year, audit year, and the subsequent years. If there are schedules attached, these should also be included in the comparison. From this comparison you may notice large fluctuations or no fluctuations at all between the years. Either of these situations could warrant further questioning and/or audit work.

AUDITING A BALANCE SHEET ACCOUNT AND SCHEDULES M-1 AND M-2

The steps involved in a balance sheet audit are different than those for the income statement. In a balance sheet audit, you are concerned with analyzing the yearend components of an account and the related tax effect on the income statement. This differs from an income statement approach which emphasizes entry selection throughout the whole year.

Taxpayers may take the position an income item is not required to be recognized for tax purposes in the year of audit, but will recognize it for financial purposes. The same holds true for expenses, but emphasis may be on acceleration for tax purposes. In both scenarios listed, a Schedule M-1 adjustment will have been made to account for the differences.

For example, taxpayer is on the cash method of accounting for tax purposes under IRC section 448, but on the accrual method for book. Accounts receivable had the following balances: $48,000 at the beginning of the year and $65,500 at the end of the year. The following balance sheet and Schedule M-1 shows how this would appear:

Schedule L: Balance Sheet

	Beg of tax year	End of tax year
	)))))))))))))))))	)))))))))))))))))
Accounts Receivable	$48,000	$ 65,500

Schedule M-1:

1. Net Income (Loss) per books	89,714
2. Federal Income Tax	30,286
	)))))))
6. Add lines 1 through 5	120,000
7. Income Recorded on books this year not included on this return:	
Accts Receivable (65,500-48,000)	17,500
	))))))
9. Add lines 7 and 8	17,500
	))))))
10. Income (line 28, page 1) line 6 less line 9	102,500
	4444444

When the Schedule M-1 shows income and/or expenses handled differently between book and tax, questions should be raised as to the reasons why. Some reasons may have merit, while others will not. In either case, taxpayers should be questioned regarding their authority for handling the issue in a particular fashion. In addition, research the issue and draw your own conclusion as to the proper handling of the issue.

In regards to manufacturing cases audited, different balance sheet accounts were examined in each audit and only those found to be of significance will be discussed. If a balance sheet account is not discussed, no inference should be drawn that an audit issue may not exist. Accountants can classify accounts altogether differently then those listed below. Therefore, you will never know what to expect. In addition to discussing the Schedule M-1 and M-2, the following balance sheet accounts will be discussed:

1. Cash
2. Accounts Receivable
3. Inventory
4. Loans to/from Shareholders
5. Building and Equipment
6. Accounts Payable, Other Current Liabilities, and Other Liabilities
7. Capital Stock/Capital Account
8. Retained Earnings

Cash

The cash account is very important because it provides an indication of what to expect during the audit (that is, poor bookkeeping versus good bookkeeping, weak internal controls versus strong internal controls, missing records versus very organized, detailed records). In the cases which had poor bookkeeping, missing records and lack of proper internal controls, more difficulties were encountered by examiners. However, in the majority of these cases, significant adjustments were made as a result of the poor bookkeeping.

The audit techniques performed on the cash account include:

1. **Reconciliation of the book balance to the return**

   If cash does not reconcile, inquire into the reasons why. There should be no adjustments to get from the book to the return since no timing or permanent adjustments are required.
2. **Reviewing the yearend bank reconciliations**

Secure all the bank statements for the entire year and all yearend reconciliations. Review the yearend bank reconciliations for accuracy and for any old outstanding checks beyond the time period they may be honored by the bank. Each bank may be different, but the industry standard is 6 months. To review the bank reconciliation for accuracy, perform the following:

a. Compare the bank statement balance with the per bank balance in the reconciliation.

b. Trace any deposits in transit from the reconciliation to the books to determine whether they have been included in the book balance.

c. Trace any bank credits to the books for proper inclusion (that is, interest income).

d. Inspect the list of outstanding checks and question any old outstanding checks. In addition, any large dollar checks still outstanding at yearend may want to be questioned. A reason to question a check of this nature is because the taxpayer may not have booked an expense through accounts payable but instead went directly against the cash account. The following is a typical entry which bypasses the accounts payable account:

   DR Expense
   CR Cash

   In the entry above, the taxpayer may void this check in the subsequent tax year because it was not a valid expense. What they have done in effect is lower their taxable income for the audit year by writing a check and voiding it the next year. When they void it the next year, this increases their taxable income in the subsequent year because they reverse the entry above. This adjustment becomes a timing issue. However, it could have a dramatic tax effect if the expense lowers the taxpayers taxable income enough whereby the tax rate for the year is changed from a higher to a lower bracket. In addition, there may be a tax bracket change between the 2 years either as a result of a law change or the taxpayer anticipating the subsequent year will not be as profitable.

e. Question any material bank debits to determine the reason for them (service charges, purchasing checks, customer checks having NSF).

f. Foot the reconciliation and trace to the general ledger. Question any differences and if necessary, propose adjustments. Sometimes the taxpayer may not know where the difference is from. It may take you a long time to find the difference if it can be found at all. Therefore, propose an adjustment

to the cash account on the Form 4549. By adjusting the cash account to the correct amount, the offsetting entry will be to the retained earnings account which is in effect taxable income. If the taxpayer does not agree with the adjustment, the burden is now on the taxpayer to prove this was not income. Therefore, try to rule out any loans or capital contribution which may not have been recorded.

g. Inspect subsequent months bank statements in the next tax year for any unusual items.

h. Inspect the subsequent month bank statement and reconciliation to determine whether any deposits were not included in the yearend bank reconciliation (deposits posted 1 to 3 days after the close of the year). It may have been necessary for these deposits to have been included in the yearend bank reconciliation. Again this would be a timing adjustment only and it may or may not have an effect on the balance sheet.

   For example, if there was a collection of an accounts receivable, an adjustment to taxable income may be necessary if the taxpayer has credited accounts receivable in the audit year for the in-transit deposit not included in the yearend reconciliation. By failing to debit the cash account, the balance sheet is now out of balance. To correct this problem, the taxpayer may force the balance sheet accounts to balance or they may have a balance sheet which is out of balance.

   If on the other hand, the taxpayer's bank statements do not fall on the same date as the yearend, other work is necessary to reconcile the account. Sometimes the taxpayer will request a cut-off statement from the bank which ends on their yearend. This is very helpful if available. If the taxpayer did not request one, the same steps above should be used. On the subsequent months bank statement, it is necessary to perform some of these steps. Review the subsequent months bank statement for any transactions up to the yearend date.

3. **Review bank statements for unusual items and electronic transfer**

   Review the bank statements for any unusual items which are outside the normal course of business operations (that is, large withdrawals, deposits in round numbers, electronic transfers in or out). Trace these transactions to any other bank account utilized. Raise questions regarding transactions that cannot be traced.

4. **Scan canceled checks and compare to the disbursements journal**

   Scan a few months worth of canceled checks (if a small company, maybe the whole year, time permitting). Compare the cash disbursements journal with the canceled checks selected. When scanning checks, be aware of:

   a. Any differences between the payee on the canceled check and the disbursements journal

   b. Any unusual payees which do not correlate with the taxpayer's business

   c. Endorsements which are different than the payees name on the face of the check

   d. Checks cashed at grocery stores or check cashing places

   e. Hand written endorsements or noncorporate entities.

   If checks are found with these conditions, write down as much information as possible such as check number, date, payees name, vendor number if present, dollar amount, and the bank account number used with the endorsement. Trace the questionable checks back to the general ledger account and the taxpayers retained copies of Forms W-2 and 1099. By performing these steps, you may find adjustments for personal expenses, possible employment tax issues, or even a nonfiler.

   The employment tax issue may be either possible payments made to employees which did not get reported on a Form W-2, 940, or 941 or for payments made to independent contractors not reported on a Form 1099. In addition, there may be a problem with the amounts reported on Forms 1099 filed. For additional information on how to handle additional payments paid which were not reported on the information return or for payments not reported on any information return, see the chapter on employment taxes, information returns, and backup withholding.

   If vendor reports are available, request them for the individuals in question. This may save time by listing all pertinent checks. If unable to obtain a vendor report, decide whether to expand the scope to include additional months or accept the months scanned. Sometimes you may be able to pinpoint to the general ledger account the questionable payments are being booked. However, many times the payments may be spread among many different accounts.

5. **Review bank statements for any income earned on bank accounts**

   Review the accounts to determine whether the account has earned any interest. Any interest should be traceable to an income account. In addition, if the taxpayer has reported interest income on the return, this should be traced back to the bank statement. Additional bank accounts the taxpayer had not included on the balance sheet can be found by following this step.

Accounts Receivable

One of the larger accounts on the balance sheet is accounts receivable. IRC section 448 gives a brief definition of who is not allowed to be on the cash method of accounting. Treas. Reg. section 1.446-1(c)(2) requires taxpayers to be on the accrual method of accounting if inventories are necessary. Treas. Reg. section 1.471-1 provides the criteria for when inventories are necessary. Therefore, most manufacturers will be prohibited from using the cash method of accounting for tax purposes. Thus, there should be some accounts receivables listed on the balance sheet. If none are shown, question the accountant for the reasons why. This should then be verified. A valid reason encountered may be that all jobs required payment up front. Therefore, customer deposits were listed instead, which are liabilities and not assets.

Because the taxpayer will, for tax purposes, try to defer income as long as possible, you will not be able to use the same audit approach as if a financial audit was being performed. For financial accounting, recognizing income at an early stage makes the company appear stronger than they may actually be. Different audit steps are used for a tax audit than would be used for a financial audit.

Audit techniques used for accounts receivable are listed below to provide you with some guidance. The following steps do not have to be worked in the order listed, but it is recommended since this sequence starts with the easier steps and progresses to the more complex and time consuming ones.

1. **Reconciliation of the book balance to the return**

   Reconcile the accounts. Question any differences between the books and return by first reviewing the adjusting journal entries at yearend and/or the Schedule M-1. If still unable to reconcile, question the accountant. Be concerned with the possible write-off of a bad debt reserve. The Tax Reform Act of 1986 limited the use of the reserve method for bad debts under IRC section 166. However, taxpayers have tried to use the reserve method either by setting up the reserve directly on the books and not making any adjustments through the Schedule M-1 or by netting their accounts receivable with the reserve, with again, no Schedule M-1 adjustment. If the balance sheet lists an Allowance for Doubtful Accounts, pay

close attention to it to determine if any increase in the reserve was written off.

The taxpayer can increase the reserve for financial purposes all they want, but there should be a corresponding M-1 adjustment reflecting this increase. If no M-1 adjustment is made, a possible issue exists. As for the direct write-off against the accounts receivable, this is usually only found if a direct line-by-line reconciliation is performed. The taxpayer will have their reserve account on the books but when it is recorded on the return, the reserve amount is not recorded as a separate line item. Again if this is found and no M-1 adjustment was made, a possible issue exists.

2. **Review yearend adjusting entries**

   Review the yearend adjusting entries to go from book to return for any unusual entries or entries not made. As mentioned above, the taxpayer may try to disguise reserves. For example, a reserve for defective products was found during the review of the yearend adjusting entries.

3. **Reviewing the accounting records**

   Review the accounting records to determine exactly what type of parties or customers make up accounts receivables. If a computer is used for bookkeeping, you will probably be reviewing an accounts receivable aging schedule. If the system is based on manual entries, either partially or fully, you will probably be reviewing a summary of all the accounts receivable ledger cards. Ask questions at this stage to gain an understanding of how the taxpayer prepared their schedules and their policy regarding write-offs.

4. **Run 10-key check**

   Never be under the impression that the schedules provided will foot or cross foot, even if they are computer generated. Easy and some times large adjustments are found when math errors have been made. A few cases worked have resulted in large adjustments to the accounts receivable because they were understated.

5. **Tie ledger cards to the reports**

   If there are numerous ledger cards, review a sample. If there are only a few, tie these ledger cards back into the schedules provided. In addition, foot some of the ledger cards on a sample basis to make sure that controls are in place.

6. **Scan ledger cards**

Scan the ledger cards looking for anything unusual about the clients name, address, balances outstanding, and if listed, their credit limit. Sometimes the taxpayer indicates on the ledger card the credit limit allowed the client. By doing this they have a built-in control whereby the credit manager can stop any order which exceeds the credit balance allowed.

One adjustment proposed resulted from this check. When scanning the ledger cards, the agent noticed the shareholder's son-in-law's ledger card had an open balance (no credit limit). The balance in the account kept increasing with very few payments being made. Finally, the son-in-law's retail store went out of business in the subsequent year. The balance of the account was written-off as uncollectible. No attempt was made to collect from the son-in-law or the daughter. The agent proposed an adjustment at the corporate level under IRC section 166 and an adjustment at the shareholder level under IRC section 301 for the amount written off as uncollectible.

7. **Review the accounts receivable reports**

Review the accounts receivable report to determine if credit balances exist. If credit balances exist, raise questions as to the age of the balances and the reason for the balances. If the balances are old and no activity has occurred on the account in many months or years, consider an income adjustment. If the balances are old, there is a good possibility the taxpayer is not going to refund the money or their client, for one reason or another, failed to use credit memos issued on past returns or allowances. What they have in effect is income.

To illustrate this, the following is the entry the taxpayer would most likely make when their client made payment even though it was more than the original sale amount:

DR Cash
CR Accounts Receivable

To clear the accounts receivable credit off the books, the taxpayer should make the following entry:

DR Accounts Receivable
CR Income

Along with this audit step, compare bad debts written off during the year with this report. The taxpayer may be premature in their writeoff policy. Some indications may be:

a. Sales still being made to their client after the write-off

b. Many accounts written off in prior year being brought back into income in the subsequent year

c. Sales made to their client up to the end of the tax year.

8. **Compare the recorded amount with the invoice**

   If all these transactions are handled by check, this step is not performed. If internal controls are adequate, this step can be bypassed in most cases.

9. **Inspect subsequent year billings**

   Inspect subsequent year sales invoices and compare them with yearend inventory records. Many taxpayers avoid billing their clients until the day(s) after the end of the tax year, but will not include the goods in finished goods inventory for one reason or another. This audit technique is easier with smaller companies than a larger shop which has the capacity to produce in large volumes at a very fast rate. However, this does not preclude this technique from being applied to larger manufacturers.

   When inspecting the subsequent year billings, if you find many customers being billed a few days after the close of the tax year, inspect the yearend inventory records to determine if the taxpayer had inventory on hand at yearend to fill these orders. If the taxpayer did not have the inventory to support these invoices, ask why and how they were able to invoice a few days after the beginning of the new tax year.

   If these invoices are for finished products which were not included in the yearend count, secure production schedules from the beginning of the new year up to the date of the invoice. From these, determine if the taxpayer had manufactured the product after the yearend inventory count. If the product was not manufactured in the new year, an ending inventory adjustment will be necessary.

   If the taxpayer does not use production schedules, you will have a problem trying to determine if the product was manufactured in the new year. Scan the billing invoices and the shipping documentation for these invoices. Then ascertain from the taxpayer the production times required to complete a product. From this information, you should be able to estimate an acceptable date as a cut-off date for the matching of the invoices with the yearend inventory count.

Example 1

A furniture manufacturer's subsequent year billings were inspected. The agent noticed about 23 invoices billed the day after the yearend. This taxpayer did not bill on a daily basis but instead waited until they accumulated a few billings before the invoices were prepared. Three other groups of invoices were billed only a few days apart. Then another group was billed on the 10th of the month, with the next group billed 7 days later. Based on this, the agent noticed there was a natural break between the 10th and the 17th. He decided to cutoff this check at the invoices issued after the 10th. The invoices included in this check were issued on the 1st, 2nd, 4th, 9th and 10th. The agent scheduled out these invoices and then traced back to the ending inventory. A few items were traced to the ending inventory count, but the rest were not. At this point, a 10-key tape was run on the invoices not traced to ending inventory. The total for these 10 days represented almost 10 percent of the total sales for the subsequent year.

The adjustment is computed using either one of two different methods. If the company keeps production schedules, use these to determine how far along in the production process the product was. From these, you should be able to determine the costs incurred as of the end of the year.

Two notes about this technique. First, the time frame for production from start to finish is longer for a custom shop than it would for a production shop. The reason for this is the custom shops are slower in their production because of the detail involved. When using this technique, take this into consideration when trying to determine a cutoff date. In the previous example, this was a custom shop and the cutoff date was determined to be the 10th.

Second, you may be able to take the position the invoices in question should have been in income in the audit year instead of inventory. This will require more work such as reviewing shipping invoices or contacting the taxpayer's customers.

Inventory

Refer to the chapter on inventory for audit techniques.

Loans to/from Shareholders

During the initial interview, inquire as to the existence of loans and the taxpayer's policies with respect to the loan, repayments, interest rates, and collateral.

Review the corporate balance sheet for the existence of loan accounts either to or from the shareholder. No entry on the balance sheet for shareholder loan accounts does not mean there are no outstanding loan balances. In several cases, the shareholder loans were included in asset and liability accounts other than the normal loans to/from shareholder account. Once the existence of a shareholder loan is

established, the concern is whether the loans are arms length transactions (that is, length of loan, interest rate, etc.). The shareholder could be receiving an interest free loan. They may be taking money out of the company tax free, through forgiveness of the loans by the corporation at a later date. Request copies of the loan documents. If loan documents exist, they should show the terms which you can then validate. If loan documents are not available, review the corporate minutes for a possible mention of and the details of the loans.

In regards to interest generated by a loan from shareholder, inspect the payables accounts for a possible write-off of the interest owed the shareholder which has not been paid. IRC section 267(a)(2) states the corporation and the shareholder (who must hold a greater than 50 percent interest in the company either directly or by attribution) will be put on the same basis of accounting, usually cash basis, to determine when a write-off is allowed, even though one is an accrual basis and the other is cash basis. In simpler terms, the corporation is allowed a deduction when the interest is paid, not when it is accrued. If the corporation has accrued the expense, inspect the Schedule M-1 to determine whether the amount has been backed out for tax purposes.

Example 2

During the audit of a corporation with a tax year 9206, the agent noticed the corporation had deducted $125,000 as interest expense which was related to a shareholder loan. Upon further review, it was found the corporation had only paid $75,000 with the other $50,000 being an accrual. This accrual of $50,000 was finally paid prior to the end of the 1992 year. Even though the shareholder was required to include the full $125,000 in his 9212 year, the corporation was not allowed a deduction for the accrual of $50,000 in the 9206 year, but instead was allowed it in their 9306 year.

1. Demand Loans

Often, the loans between the taxpayer and its shareholder will be demand loans in lieu of formal loans with a stated rate of interest and repayment period. In the case of demand loans, special rules apply. Under IRC section 7872 the foregone interest on such below market interest rate loans is treated as transferred from the lender to the borrower as of the last day of the calendar year and re-transferred immediately from the borrower to the lender as interest. There is a $10,000 de minimis exception for compensation related and corporate-shareholder loans that do not have tax avoidance as one of the principal purposes (IRC section 7872(c)(3)).

When a corporation makes interest free (or low interest) loans to its shareholders, the shareholders' family members, or other related parties as discussed in IRC section 318(a), the following actions are deemed to have occurred:

a. The shareholder has received a constructive dividend in the amount of the foregone interest to the extent of earnings and profits.

b. The corporation receives a like amount of interest income.

c. After the 1990 year, the shareholder will only be allowed a deduction for the interest deemed paid to the corporation if they can demonstrate the expense is investment related.

If the corporate loan is made to an employee, who is unrelated to the shareholder as discussed in IRC section 318(a), the scenario is similar except:

a. The foregone interest is characterized as additional compensation to the employee.

b. The corporation receives deemed interest income in a like amount.

c. The corporation can deduct the amount as compensation expense but may be liable for employment taxes on the additional wages.

d. After the 1990 year, the employee will only be allowed a deduction for the interest deemed paid to the corporation if they can demonstrate the expense is investment related.

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

a. The shareholder receives interest income in the amount of the foregone interest.

b. The corporation has deemed interest expense in a like amount.

c. The foregone interest will be treated as a capital contribution by the shareholder (Treas. Reg. section 1.7872-4(d)).

Although the transfer of taxable income between entities may appear to be offsetting, there can be significant tax impact in the reallocation, depending on the relative tax brackets of the borrower and lender and the deductibility of the interest

deemed paid.

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

Despite the fact the computation may seem tedious at first, adjustments can be substantial and are easily sustained.

2. **Thin Capitalization**

Upon reviewing the loans from shareholder and the common stock accounts, a thin capitalization issue may exist if there is little or no common stock and there is a large loan from the shareholder. IRC section 385 was enacted for the purpose of determining whether an interest in a corporation is to be treated as stock or indebtedness. Under this section, there are five factors which need to be considered in pursuing this issue. If you encounter this issue, review this Code section along with any court cases related to this issue. In the narrative below, a few court cases are discussed which should be researched further.

The objective in a thin capitalization issue case is to convert a portion, if not all, of the loans from the shareholder to common stock. By performing this conversion, an adjustment to interest expense becomes necessary because the loans at this point are considered non-existent. The interest paid by the corporation, which has been disallowed by you, is now classified as a dividend at the shareholder level to the extent of earnings and profits.

The courts have not been favorable in the Government's pursuit of this issue. (***Fin Hay Realty v. United States***, 22 A.F.T.R. 5004, 398 F.2d 694). In the courts opinion equity is considered a higher risk, whereas to loan money is considered a lower risk. Thus to loan money to one's corporation is in effect limiting their risk because equity is only allowed a capital loss, but loans can be afforded the benefit of being classified as ordinary losses under IRC section 166. In addition, the courts have stated a shareholder would not loan their corporation money at extraordinary rates because this would be self-defeating as it would damage their own corporation. In the ***Fin Hay*** case, the presiding judge quoted ***J.S. Biritz Construction Co. v. C.I.R.***, 68-1 U.S.T.C. ¶ 9118, at which time the court made a strong point about loans and equity.

"Financing embraces both equity and debt transactions and we do not think the courts should enunciate a rule of law that a sole stockholder may not loan money

or transfer assets to a corporation in a loan transaction. If this is to be the law, Congress should so declare it. We feel the controlling principle should be that any transaction which is intrinsically clear upon its face should be accorded its legal due unless the transaction is a mere sham or subterfuge set up solely or principally for tax-avoidance purposes."

Even though this is not a particularly easy issue to work, this should not deter you if the situation arises. In one case, it was noted a corporation had no common stock outstanding. It was determined from the corporate minutes that they had converted the common stock to loans from shareholder in a prior year and had paid interest on this amount every year since. The agent proposed the following adjustments:

a. Increase to the common stock account;
b. Decrease to the loans from shareholder account;
c. Disallowed a portion of the interest expense;
d. Reclassified interest income at the shareholder level to a constructive dividend.

Building and Equipment

In this section, the term account(s) and depreciation schedule are synonymous.

The building and equipment account is be one of the larger balance sheet accounts for a manufacturer return. However, combined with the accumulated depreciation account, the net balance of the two will usually decrease every year. When reviewing this account, the notes made during the initial interview and the tour of the business help determine what should or should not be in the account.

For example, corporate officers may be driving expensive luxury vehicles which do not appear on the depreciation schedule. This could mean the vehicles are being leased by the corporation. Be aware of potential adjustments under the luxury automobile limitations of IRC section 280F.

During the tour of the business if all the machinery looks old, ask questions about any equipment purchases made recently which appear on the depreciation schedule.

The audit techniques used on the building and equipment account include:

1. **Reconciliation of the book balance to the return**

   This should be the first step performed before proceeding further. This may be reconciling one account in the books to the building and equipment line on the return or different classifications of fixed assets (machinery, furniture & fixtures,

etc.). Or, it could mean reconciling each piece of equipment which has their own account in the books to the building and equipment line on the return. In any case, reconcile and question any differences.

2. **Review the depreciation schedule**

   If a depreciation schedule is not attached to the return, request one. Reconcile this depreciation schedule to the book balance for the original cost of the equipment. The accumulated depreciation may not balance because of the different methods afforded the taxpayer both for financial and tax purposes. The depreciation schedule is usually kept for tax purposes. If the taxpayer is using a different method for book than tax, a Schedule M-1 adjustment should appear for the current year differences.

   Compare the depreciation schedules for the prior year, audit year, and the subsequent year returns for any personal or nonbusiness related assets, changes in the depreciation method or the life of the assets, and any possible equipment dispositions not reported on the return. If these items are found, ask questions and, if necessary, propose adjustments under IRC section 162, IRC section 168, and/or IRC section 1231.

   Review any IRC section 1031 like-kind exchanges to verify that the requirements for the exchange have been met. To find these transactions, inspect the invoices for any new equipment purchases made during the year. From this, determine if the basis of the new equipment was reduced by a trade-in.

   In one case, the agent reviewed the new equipment purchased during the year. One of the purchase invoices showed a larger dollar amount being paid for a vehicle than what was recorded on the depreciation schedule. Questions were asked. It was discovered a company vehicle was sold to a third party for cash. They had reduced the basis of the new vehicle by this amount. No gain was reported. Based on this, an adjustment was proposed for an ordinary gain on the cash received and the equipment basis was adjusted to the actual amount paid. The taxpayer would have been allowed an additional depreciation deduction, but since the equipment was listed property, the depreciation deduction was limited to the amount already claimed on the return.

3. **Review the method of depreciation**

   Be aware of the specific methods allowable by the Code when reviewing the depreciation schedule. For instance, one should be aware of the various classifications (3, 5, 7 year, etc.) as well as the methods available (200-percent declining balance, straight line, etc.). Also be aware of the various conventions

(half-year, mid-month, or mid-quarter) for new acquisitions or disposals of equipment.

If an IRC section 179 deduction is being claimed, verify the original basis of the asset(s) has been adjusted to reflect the proper deduction in subsequent years.

The vast majority of the tax return depreciation schedules are now computerized. If improper methods are input, then the resulting computation will be incorrect.

As a result of the Tax Reform Act of 1986, a majority of manufacturing equipment placed in service after this act will be depreciated over a 7 year MACRS life (IRC section 168(e)(3)(C)). Under MACRS, any building acquired after 1986 is to be depreciated over a 31.5 year straight line method. In addition any leasehold improvements made post 1986 are now required to be depreciated over the same 31.5 year life, not the life of the lease agreement as was the law pre-1987 (IRC section 168(i)(6)(A) and IRC section 168(i)(8)). As a result of the Omnibus Budget Reconciliation Act of 1993, any real property placed in service, with exceptions, on or after May 13, 1993, is required to be depreciated over a 39-year straight-line method.

Since the allocation between building and land can make large differences in the amount of depreciation allowed, review the allocation. If necessary, make an engineering referral for assistance in determining the correct allocation. In addition, inspect how the taxpayer is depreciating the building. In one case, the taxpayer had included the land in the calculation for depreciation which resulted in an accelerated write-off. The taxpayer knew they were not allowed to depreciate land because they had a separate line item for it. The building should have been written-off over 30 years, but with the land being included in the basis for depreciation, the write-off period was effectively 22 years.

Per IRC section 168(g), equipment used predominantly outside the United States must use the alternative depreciation system (ADS). This method will extend the life of the asset. For example in the case of woodworking equipment, the usual life is 7 years but under ADS the life is now 10 years. Therefore, if the taxpayer owns a maquiladora and leases equipment to them, make sure the taxpayer is using the ADS method.

4. **Scrutinize self-constructed assets**

Some taxpayers have constructed their own assets (buildings or improvements). When this occurs you should be concerned with direct write-off's of expenses associated with the construction of the asset. The larger dollar items will be capitalized but many of the smaller items will be expensed. Remember many small

items can make a large adjustment. IRC section 263A applies to self-constructed assets.

5. **Select a sample of equipment and trace back to factory**

   Select a sample of the equipment listed on the depreciation schedules and trace them to the factory to verify their existence. The problem with this is the equipment selected may have a general name (for example, table saw) and the taxpayer may not have the receipt to verify the manufacturer and serial number. This usually occurs when the equipment is older. Once the sample is pulled and traced to the factory, question any differences or missing equipment. There may be a possible sale of equipment which was not reported or an IRC section 1031 exchange which would require verification.

Accounts Payable, Other Current Liabilities and Other Liabilities

Since each of these three accounts is similar in nature, the same audit techniques can be applied for all of them.

An accounts payable account is used to record the daily expenses of the taxpayer, such as goods and services. Since these expenses are vital to the business, they are usually paid in a timely fashion. Finding old expenses is highly unlikely, unless the company is having financial problems. Because of the nature of the account, it is usually easier to audit because the amounts which comprise the account have already been expensed on the income statement. The taxpayer has the burden of verifying these amounts. In reality, auditing this account becomes a substantiation audit.

Both the Other Current Liabilities and Other Liabilities are accounts which are not used on a daily basis. They are instead used for accruals which do not ordinarily enter through the accounts payable system. For example, you will usually find the current portion of a note payable listed in this section. If an adjustment is made in this area, the effect will not always be to taxable income for the year. Other accounts you may find under these headings are: accrued payroll taxes, sales commissions, workers compensation insurance, allowance for advertising, and reserves for estimated expenses or contingencies.

You may audit accounts payable for transactions occurring during the year but due to the number of transactions this method can be cumbersome. Also, this method is similar to an expense method of auditing and could simply be duplicated work. When auditing this account, concentrate on the yearend balances. By auditing the yearend balance, you are able to verify whether the taxpayer has expensed items not meeting the conditions of IRC section 461(h) and Treas. Reg. section 1.461-1(a)(2) at yearend or were not IRC section 162 expenditures. Treas. Reg. section 1.461-1(a)(2) has

three conditions which are necessary for the amount to deductible:

1. The liability must exist.

2. The liability can be reasonably determined.

3. Economic performance has occurred.

If one of the three conditions is not met, an adjustment may be necessary.

Adjustments necessary to the accounts payable account will most likely be adjustments to taxable income because the amount adjusted was written-off somewhere on the income statement. If a timing adjustment is found, attempt to find which income statement account was affected because it may lead to other audit areas or it may have an effect on the IRC section 263A adjustment. As with any adjustment, materiality will dictate how much time and effort will be necessary. If the account cannot be located for whatever reason, make an adjustment to the accounts payable account directly on Form 4549. If the adjustment found is of a personal nature, make every attempt to find the account affected, so concentration can be placed on this account for possible further personal adjustments.

Since accounts payable is fairly easy to audit, the steps involved are fairly simple. Following are the steps to take in auditing this account:

1. **Reconciliation of the book balance to the return**

   Obtain the yearend trial balance and reconcile the accounts to the tax return. By performing this step, you are able to determine if the tax return balance is comprised of more than one general ledger account and possibly set the scope of accounts to be audited.

2. **Secure and inspect the yearend accounts payable schedule or breakdown of the ending balances**

   Try to secure a copy of an accounts payable aging schedule or breakdown of the ending balances which lists all amounts which make up the yearend balance. If the taxpayer does not have an aging schedule, a schedule of who is owed money should be secured. If the taxpayer states they do not have a list, consider a possible adjustment for the entire accounts payable balance because this account is used for the daily activity of the business. Under the accrual method of accounting if an entry is made to the accounts payable account, the offset is to an expense account which in all likelihood has been written off by the taxpayer.

So if the taxpayer is unable to provide a list of their accounts payable, in effect they have told the examiner they do not have any expenses. Thus an adjustment is warranted.

As for Other Current Liabilities and Other Liabilities, if the taxpayer does not provide a breakdown, you will be unable to consider an adjustment for the entire balance because of the nature of these accounts. Further work is necessary to establish:

a. Whether these amounts have ever been expensed

b. If they have been expensed, whether they were expensed in the previous years and/or the current year

c. Whether the accrual meets the tests described in IRC section 461(h).

This is necessary because if it is determined a change in accounting method is required, IRS procedures (Rev. Proc. 92-20, 1992-1 C.B. 685) dictate how the adjustment is handled in the year of audit.

Once a schedule is secured, perform the following audit steps. These steps can be used for all liability accounts:

a. Foot and reconcile

   Foot and reconcile the balance to the general ledger amount. Question any differences. If necessary, propose adjustments.

b. Inspect for old payables

   You will only be able to perform this step if an aging schedule is secured. If no aging schedule is provided, the step listed in section (c) below can be used.

   Inspect for old payables which may require an adjustment. Since the Code does not specify a time period, use your judgment in determining what is considered old. A good starting point could be 6 months, but this could change depending on many factors. Some factors would be the financial condition of the taxpayer, industry standard and whether the amount is being disputed.

   If an old payable is found and the taxpayer has indicated they are not going to pay, make an adjustment for this payable.

c. Sample payees/accounts

Make a sampling of the payees/accounts. Request documentation to determine whether the deductions meet the three conditions listed in Treas. Reg. section 1.461-1(a)(2) which would allow the deduction.

In addition, inspect for payables which are old and still outstanding as of the audit date. If old payables are questionable, inspect the subsequent year payments to verify the amount was actually paid. If it is determined these payables have never been paid, an adjustment may be warranted.

3. **Scrutinize any yearend adjusting journal entries**

Review and question any adjusting entries at yearend to determine if they meet the three conditions of Treas. Reg. section 1.461-1(a)(2) at yearend. If the entries are questionable, request documentation and verify the amount. If necessary, consider an adjustment to accounts payable if the amounts do not meet the conditions of Treas. Reg. section 1.461-1(a)(2).

Capital Stock/Capital Account

Since many of the manufacturing companies audited have been around for a few generations, a reconciliation of the ownership account through the stock certificates/stock book is usually necessary. Compare this reconciliation to the Schedule E or an ownership schedule attached to the return. Ask questions if the ownership does not reconcile to the return. Reconcile the stock ownership early in the audit so any adjustments for personal usage of corporate assets or distributions of corporate assets can be proposed to the correct individual.

The reconciliation of the ownership account is very important in a TEFRA and non-TEFRA S-Corporation or partnership examination because of the nature of these entities. Any adjustments proposed at the entity level will in most cases have a direct tax effect at either the shareholder or partner level.

Example 4

An S-Corporation with three shareholders had allocated 100 percent of the losses to the 80 percent shareholder and none to the other two shareholders. The agent proposed adjustments at the shareholder level to correct this allocation. From the initial interview, the agent knew the two shareholders were passive investors. Therefore their losses were limited because of the passive activity rules under IRC section 469. A minor change in the K-1 reporting resulted in a substantial adjustment.

Because many of the companies are fairly old, the older shareholders either gift their stock to the younger shareholders (usually family members) or sell the stock back to the company. Each transaction can have a tax consequence either through a gift tax or a capital gain under IRC section 1221. In addition, if a shareholder's stock is redeemed as treasury stock, IRC section 306 governs the ex-shareholder's actions with the company for up to 10 years after the sale. If the ex-shareholder fails to comply with IRC section 306, the redemption could be classified as a dividend distribution. If any of these issues are found, further research is necessary which is outside the scope of this manual.

Retained Earnings

As with any industry, manufacturers can be very profitable. With this profitability comes some issues which need to be addressed by the company and its officers/shareholders. Is the company going to expand the production area, purchase the latest equipment on the market, or even make some dividend distributions? Because possible issues can exist, review the taxpayer's balance sheet, taxable income for the year and the number of shareholders.

If the taxable income is large and the company has:

1. Substantial cash, investment assets, and/or nonbusiness assets; and

2. Substantial amounts of retained earnings (which with adjustments, equates to earnings and profits as discussed in IRC section 312)

Review IRM 531 through 537 and any outside publications to determine if a possible accumulated earnings tax issue exists before the initial appointment. Remember an accumulated earnings tax issue will only apply to closely held corporations. This issue will not exist with a publicly traded company.

The references listed previously should be reviewed before the first appointment because this may be the only opportunity for you to question the officer/shareholder directly.

At this appointment, some of the required questions should be:

1. What are the company's plans for the near future and how are they going to pay for these plans?

2. Have they made any large loans to outside vendors?

3. Are any of their large clients in financial trouble?

If the taxpayer has plans for expansion, they should be backed up with discussion in the board of directors minutes and contact with real estate brokers, equipment distributors, etc.

In an accumulated earnings tax issue, the Government has hindsight because any plans the taxpayer has discussed previously should have been started or have been finished. The courts do not allow the taxpayer the opportunity to put off their plans indefinitely. The taxpayer must make a commitment to their plans and go forward with them. Finally, remember each accumulated earnings tax issue is different than the next because the facts and circumstances of each are different. What may have applied in one case, may not in the next.

Schedule M-1 and Schedule M-2

There are two other schedules attached to the return which are intertwined with the balance sheet. They are Schedule M-1 and Schedule M-2. The main focus will be on the Schedule M-1, but a few brief comments will be made about the Schedule M-2.

The Schedule M-1 is used to convert the taxpayers book net income to the taxable income on the return. The accountant who prepares the return will eliminate items not allowed/required to be included in taxable income (for example, entertainment expense and tax exempt interest). Because of financial and time constraints, the accountant may not make all the applicable adjustments necessary to convert book net income to the taxable income. Because of this, inspect for items required on the Schedule M-1, but not included.

Many taxpayers keep their books on the cash method of accounting. At yearend, the accountant makes adjustments to put the taxpayer on the accrual method of accounting. If the accountant does not make these adjusting entries on the books, he or she will most likely make these adjustments in his or her workpapers. Since no adjustments have been made to the taxpayer's financial statements, all the adjusting entries will appear on the Schedule M-1 either as an increase (accounts receivable) or decrease (accounts payable) to book net income.

In all likelihood, the accountant will make most of the adjustments on the books. Thus the financial statements will be on the accrual method also.

When performing an audit of either the balance sheet or the income statement, remember the taxpayer can book personal expenses at their discretion. There will only be an adjustment if a Schedule M-1 adjustment was not made or the personal expenses were not included on the shareholder's Form W-2. The tax treatment is different if the personal item is not being expensed. The corporation may have handled it correctly by classifying it as a dividend or a loan repayment. This can be verified by reviewing the

Schedule M-2 or the loans to/from shareholder account.

If you determines the corporation took no position (dividend, Form W-2) on the use or distribution of corporate assets, an adjustment will have to be made at the corporate level if the amount was expensed, along with an adjustment at the shareholder level for use of these assets under IRC section 301.

Finally, in some cases, a distribution even though not expensed by the corporation (for example, distribution of appreciated property) can trigger income adjustments both at the corporate and individual levels, under IRC sections 311(b) and 301, respectively. The corporation will be treated as if it had sold the property to the shareholder at fair market value. The corporation will have to report a gain from the property on the difference between the fair market value and the adjusted basis. As for the shareholder, they will only have to report a dividend under IRC section 316 if the corporation has earnings and profits as computed under IRC section 312. If the shareholder assumes a liability attached to the property, this will reduce the dividend required to be reported by the shareholder (IRC section 301(a)(2)).

If this issue is present, make an engineering referral requesting the assistance of an appraiser.

Finally, if no earnings and profits exist, the distribution, either in the use of or the actual distribution of corporate assets, will first be allocated to a return of basis (capital). Then the remainder will be considered capital gain (IRC section 301(c)).

Some of the more common adjustments you will find on the Schedule M-1 will be the Federal Income tax per book/return, entertainment disallowance under IRC section 274(n), depreciation adjustment for the difference between the book method and the tax method, officer's life insurance, the UNICAP adjustment under IRC section 263A, state income taxes, fines, penalties, and charitable deductions.

The Schedule M-2 on smaller companies will have minimal activity. The Schedule M-2 is used to reconcile the retained earnings account with any changes occurring during the year. Most adjustments are straight forward. You will see an adjustment for book net income. However, there may be other adjustments for prior period adjustments or distributions made either in cash, stock, or property. Be concerned with any prior period adjustments and how they were handled on the return filed for the year under audit. Were the prior period adjustments included in income or expensed in the year? Ask questions and propose adjustments if these item were not handled correctly.

Some audit techniques which can be used in determining whether a distribution has been made are:

1. During the initial review of the tax return, inspect Schedule M-2 for any reported distributions to the shareholders. Do not take the absence of entries of distributions at face value. The taxpayer may have improperly reported distributions. In addition, if there is a property distribution, insure the provisions of IRC section 311 have been followed.

2. Reviewing the corporate minutes may reveal distributions of corporate assets to the shareholder. Trace these items to the Schedule M-2 and the Form 1040. If the minutes state a distribution was made and there is no entry on the Schedule M-2 or the Form 1040, question the discrepancy and if necessary propose an adjustment at the individual level, taking into consideration IRC section 312. If the distribution meets the conditions of IRC section 311(b), an adjustment at the corporate level may also be required.

3. Analysis of the yearend journal entries will also reveal whether any distributions have been made and whether the taxpayer has expensed a distribution. In one case, the examiner noticed a journal entry explanation stating the property was "given" to the shareholder. This was written off by the corporation as a gift, without taking into consideration the limitations under IRC section 274(b). This type of gift was in fact a distribution which was adjusted to reflect a dividend.

CHAPTER 5

SALES AND INCOME ISSUES

INTRODUCTION

The income analysis of the manufacturing industry does not provide any single issue which is found to be common or prevalent throughout the market. On the contrary, there appear to be a range of assorted income issues which an examiner may encounter. These issues range from simple unreported interest income to omitted sales. This section discusses those issues but many more potential income issues may exist.

The books and records used to account for income are not unique in nature except for the garment industry. Due to the specialized nature of that industry, refer to the MSSP guides for further information. In general, the books and records include the usual sales, accounts receivables, cash receipts and sometimes credit memo journals. In some cases a factoring arrangement is used to generate cash. In most cases, cash flow comes directly from sales receipts and direct borrowings.

The term "manufacturer" includes a broad range of products which are accounted for differently in regards to sales. For example, companies that produce "assembly line" goods usually report income when goods are shipped. Some manufacturers may account for sales on a modified percentage of completion method.

HOW SALES ARE GENERATED

The primary methods of sales include: Independent Sales Staff, In-house Sales Staff, Trade Shows, Newspaper Advertisements/Mailers, Sales Marts, Word of Mouth, and Public/Employee Sales.

Independent Sales Staff

Manufacturers use independent sales personnel more than any other method. Commission percentages range from 3 percent to 8 percent of gross sales generated depending upon the specific industry segment.

In-house Sales Staff

This is less common than the independent sales personnel. The staff usually include shareholders and officers who travel across the country keeping in touch with their retail customers.

Trade Shows

Trade shows are continually held across the United States and occasionally in foreign countries.

Newspaper Advertisements/Mailers

In some cases, the manufacturer works directly with the retailer in creating "mailers" which are distributed directly to the public. In most cases, the manufacturer's products are displayed along with their name. In almost all cases, the cost of the mailers is shared with the retailer and regularly netted with the sales invoices.

Sales Marts

Some manufacturers maintain showrooms in which they display their latest lines.

Word of Mouth

For example in the furniture industry, this is especially true for manufacturers involved with production of counter tops, tables, and other fixtures for banks, retail stores, and other commercial customers.

Public/Employee Sales

This generally accounts for a small percentage of total sales.

GENERAL AUDIT TECHNIQUES

Understanding the Sales Cycle

The complex adjustments usually result only if you the actual transactions along with the accounting systems. Sales analysis is no different. While a general understanding can be obtained during the initial interview, make an in-depth inquiry while auditing the specific sales accounts. The following inquiries are suggested:

1. **Understand What the Taxpayer Sells**

   Ascertain what specific goods the taxpayer sells. For example, some manufacturers produce certain parts of their own goods but import other parts from overseas. If old or current catalogs are available, request one to review and notate the various lines. In some cases, the taxpayer also produces replacement parts for their own goods which can make up a separate sales category. In other cases, the taxpayer may sell custom made goods.

2. **Profit Margins**

   What type of profit margins are made on the goods? How were they determined?

3. **How Are Sales Generated**

   Ascertain from the taxpayer whether independent sales personnel are enlisted or whether showrooms are used or any combination of the above mentioned methods.

4. **Sales Recording Dates**

   Does the taxpayer record sales when the goods are shipped or when the customer acknowledges receipt of the goods? If the taxpayer produces custom products, do they record income when the job is completed or do they record income on an interim basis when cash is received?

5. **Discounts Offered to Customers**

   Find out whether cash, trade, volume, or any other discounts are offered or automatically taken by customers. The response to this question becomes especially crucial if the taxpayer accrues for discounts at the end of the year.

6. **How Are Returns and Allowances Handled**

   Become familiar with the mechanics and bookkeeping involved with returns and allowances. For example, when a taxpayer is notified a product was damaged upon delivery or was the wrong product, who specifically handles the complaint? Is the complaint investigated right away, if at all? If the complaint is valid, who approves the return? Is a credit memo issued? Again, responses to these questions becomes crucial if the taxpayer accrues for returns and allowances at the end of the year.

Understand the Accounting System/Internal Controls

Understanding the mechanics of the accounting systems and internal controls in effect allows the examiner to set the scope of the audit so maximum coverage is obtained in the least amount of time.

This goal is accomplished by relying upon the taxpayer's internal controls if they are effective in minimizing errors. Although this guide cannot go into the details of financial auditing, it is highly recommended that you become familiar with such audit steps as verifying sequentially numbered invoices, the handling of cash receipts, and segregation of duties.

See Exhibit 5-1 for the GAIN audit workpaper relating to sales.

SPECIFIC AUDIT TECHNIQUES

Internal Revenue Manual 4231.582

The audit guidelines established for gross receipts or sales in IRM 4231.582 along with the proper balance sheet analysis provide sufficient coverage in the income area. The IRM section is reprinted below with a few additional suggestions or observations. Consider the applicability of the steps below in conjunction with the evaluation of the taxpayer's internal controls.

(1) In the initial testing of the sales account, the following techniques may be considered:

(a) Test methods of handling cash to see if all receipts are included in income. Scan daily cash reconciliations and related book entries and bank deposits. Note any undeposited cash receipts on hand at the end of the year.

Note: Several errors have been detected using this method whereby the original billing per the sales invoice did not match the subsequent cash receipts.

(b) Test reported gross receipts by the gross profit ratio method. * * *

(c) Note items unusual in origin, nature, or amount in the books of original entry and test them by reference to original sales slips, contracts, job record book, bank deposits, etc. Also, check selected entries made at different times of the year, including some at the beginning of the year. Test check footings and postings to the general ledger.

Note: In one case, the sales journal was scanned and a one time sale was made to a company with almost the exact same name as the taxpayer. Follow up to this entry revealed a separate company which was related by common ownership. The entry was

traced to the separate company where it was determined the shareholders were allocating income and expenses between the two companies to affect the taxable incomes. In this case, one company was doing very well and the other operated at a small loss. Therefore, the reporting of income by one and the expense by the other did not result in an equal increase and decrease in tax.

(d) Review bank statements and deposit slips for unusual items.

This step was discussed in the balance sheet chapter under cash.

(e) Scan the sales account in the ledger for unusual entries. Test entries from the general journal and sales journal. Compare total receipts to total business income bank deposits and reconcile any differences.

Note: In one case the taxpayer was making large and consistent debit entries to the sales accounts. The original explanation was that the entries were returns and allowances. Upon subsequent examination it was determined the debit entries represented customer checks that could not be processed because of insufficient funds. The bank would debit the taxpayer's account (credit entry on the taxpayer's books) and the taxpayer would debit sales rather than accounts receivable. The taxpayer stated these entries were allowable under the bad debt provisions but could not refute the fact that many of these accounts were collectible in the future.

(f) Be alert to the possibility of income which may be taxable even though not appearing on the books (dealer reserve income, constructive receipt, income from foreign sources, etc.).

(2) If the results of these initial tests compare favorably with gross receipts reported, further verification would generally be based on the particular circumstances of the case. For example, a high percentage of cash receipts which are not regularly deposited or properly accounted for would be a basis for further testing.

(3) If further verification is necessary, consider the following techniques:

(a) If original receipts and records are not too numerous, match up invoices, contracts or similar documents with any records kept by job or contract and reconcile any differences. If receipts and records are numerous, test check at various intervals and also look for unusual items. If possible, test quantities of the principal product sold in comparison with production or purchases. * * *

Note: In the furniture industry, this step is especially pertinent with manufacturers who produce commercial products such as grocery counters, large shelves, or development projects. In most cases, the job must be bid for and a contract is drawn up. Be aware that supplemental contracts (also known as change orders) may be drawn up in special circumstances which should be included in income also.

(b) Check the receipts to the sales or general journal and reconcile any differences.

(c) Question any unusual sales discounts or allowances.

<u>Note:</u> See the section for common discounts and allowances given.

(d) Determine the extent to which receipts were used to pay operating expenses, liabilities, personal expenses, etc. * * *

(e) Determine the method and adequacy of accounting for merchandise withdrawn for personal use. Withdrawals should be accounted for as the merchandise is withdrawn and not on an estimated basis. Normally, purchases are reduced by the cost of such merchandise. However, the amount may be credited to sales.

(f) If the taxpayer reports on the accrual basis, determine if all receivables are included in income.

<u>Note:</u> Several timing adjustments were found by examining shipping documents for sales booked in the subsequent year. These sales were erroneously booked in the next year. The materiality, corporate tax rates and potential interest received should be considered before proposing the adjustments.

(g) Scan sales agreements, contracts and related correspondence for leads to unrecorded bonuses, awards, kickbacks, etc.

(h) If the records indicate contracts or sales may have been completed but corresponding income not reported, further inquiry should be made about the sales. If practical, check journal entries and bank deposits for the first few weeks of the following year to see if the amounts were taken into income at that time.

(i) Review workpapers made for tax return purposes and make sure adjustments are appropriate. Reconcile receipts per books with receipts reported. Resolve any differences.

<u>Note:</u> In some cases, the taxpayer was on the cash method per the books and made adjusting journal entries at the end of the year to arrive at the accrual method. These journal entries should be reviewed carefully, especially the receivables and payables for both the beginning and ending of the year.

(j) It may be necessary during the examination to secure additional records, documents, or other clarifying evidence. If such additional data will resolve matters, advise taxpayers of what is in question and the information needed. They should then be given an opportunity to furnish the information.

Note: Do not hesitate to use a summons if the records prove inadequate or the taxpayer is unresponsive to requests. In one case it was necessary to summons not only the corporate bank records but the shareholders as well. The information revealed many unexplained deposits in the form of cashier checks and cash. Ninety percent of the cashier checks were under $10,000 thereby avoiding currency transaction reports. These records along with other corporate records obtained with a summons were the basis for a criminal fraud referral.

(k) Be alert to indications of:

1. Capital gain treatment of items which may constitute ordinary income.

2. Sales made or services rendered in exchange for other goods and services which were not included in income (bartering).

3. Unreported commissions or rentals from activities operated on the taxpayer's business premises. In some cases, there may be arrangements for operating concessions or businesses such as cafes, bars, candy counters, vending machines and newsstands.

Other Recommended Income Probes

1. **Commission Expense Comparison**

   The commission expense can be used to extrapolate a sales figure for comparison with the sales reported on the return. For instance, if the majority of sales are generated through an independent sales force, you can compute an average commission sales percentage. The commission expense per the return can then be divided by this percentage to arrive at an estimated sales figure. If there is a large discrepancy between the two amounts in either direction, ascertain the reasons why.

2. **Request IDRS/CBRS Information**

   Certain transcripts are available which show Form 1099 information issued to corporations. Even though not required, some brokerage firms will issue Form 1099 INT or Form 1099 DIV to corporate taxpayers. Examination of these transcripts (BMF) may reveal bank accounts not indicated in the books and records. Currency Transaction Reports may also indicate cash transactions which would lead to further inquiries.

OTHER INCOME ISSUES

Unreported Interest Income

1. **Third Party Payments**

   This issue is more prevalent in cases where there were weak internal controls. During the initial interview, question the taxpayer as to the number of bank accounts used and whether any of those accounts are interest bearing. As was discussed in the balance sheet chapter under cash, obtain the bank statements for the entire year and at least the year ending bank reconciliation if available. Trace any interest income entries found on the bank statements through a cash receipts journal or directly into an interest account in the general ledger.

2. **Related Party Payments**

   In many cases, loans to shareholders are made for which no interest payments were made. If this is the case, then imputed interest to the corporation may be a possible issue under IRC section 7872 and the accompanying regulations. This may be an issue if the shareholders make interest free loans to the corporation as well. See the discussion in the balance sheet chapter under Loans to/from Shareholders for more detailed information.

Bargain Purchases under IRC Section 311(b)

Although not encountered often, distributions of appreciated property under IRC section 311(b) produce significant income adjustments to the corporation as well as shareholders when raised. Although some work may be involved as far as determining fair market values (appraisals, comparisons, etc.), the adjustment is usually worth the time.

Be aware of this issue whenever a sale of property has been made to a shareholder at an amount below fair market value. If these circumstances arise, IRC section 311(b) states income will be attributable to the distributing corporation AS IF such property were sold to the distributee at its fair market value.

Example 1

In one case, a building and land was distributed to three shareholders. On the Schedule M-2 a distribution to the shareholders was reported in the amount of $20,000. The agent obtained an engineering appraisal of the building and land. It was determined the distribution was made at a value well below fair market value. Because of the difference in the appraised amount and the amount reported on the Schedule M-2, the agent made the following adjustment to the corporation under IRC section 311(b):

	FMV of Building/Land
minus	Adjusted Basis of Building/Land
	)))
equals	Amount attributed to corporation as income

In this case the difference between the two amounts produced a $120,000 tax adjustment to the corporation. The distribution resulted in adjustments to the shareholders' returns as well.

In another case, a classic automobile was sold by a corporation to a shareholder for $20,000. At the time of the sale, the vehicle had been fully depreciated so that the adjusted basis was zero. The corporation reported the $20,000 gain on its Form 1120. Research of Classic Car Guides revealed the fair market value was $60,000. This resulted in an adjustment to the corporation of approximately $40,000 as well as an adjustment to the shareholder's return.

Sales and/or distributions of property to shareholders may be discovered by analyzing the fixed assets schedule and notating any removals of assets since the beginning of the year. Be especially aware of vehicles dropping off the schedule. If sales are reported on Form 4797 of the Form 1120, ascertain to whom the sales were made. If the sales were made to shareholders or related parties, consider appraisals or contact with third parties to determine fair market values.

Lease Inclusion Income: Passenger Automobiles

In 1984 IRC section 280F was enacted to provide limitations on the amount of recovery deductions allowed on luxury automobiles. Because leased automobiles did not fall under the provisions of IRC section 168 in terms of cost recovery, IRC section 280F(c) provides a limitation on the amount of lease deductions for passenger automobiles.

This provision does not provide for a limitation by reducing the lease deduction but rather requires the taxpayer to include a predetermined amount in their income. These predetermined amounts are based upon the fair market value of the leased vehicle as well as the term of the lease using tables provided by the Federal Government.

The regulations provide different tables depending upon what year the vehicle was first leased. Treas. Reg. section 1.280F-7 provides tables which cover vehicles leased after December 31, 1986, and before January 1, 1989. Rev. Proc. 89-64, 1989-2 C.B. 283, provides for vehicles leased in calendar year 1989. Rev. Proc. 90-22, 1990-1 C.B. 504; Rev. Proc. 91-30, 1991-1 C.B. 563; and Rev. Proc. 92-43, 1992-1 C.B. 873, provide the tables for the calendar years 1990, 1991, and 1992, respectively.

CONTRA-SALES ACCOUNTS

The examination of sales should include a probe into the various contra-sales accounts used by the taxpayer. These include returns, various allowances, cash discounts, and other specialized reductions. In most cases the manufacturers have separate general ledger accounts for the various deductions. However, in a few cases, the return or allowance is deducted directly against the sales accounts.

A few of the common returns, allowances, and discounts are discussed below.

Returns

Depending upon the size of a manufacturer, returns may be a significant number. Returns are not found to be common with manufacturers who produce custom goods. Mistakes made by the custom manufacturer will be corrected before delivery. On the other hand, returns are more significant for manufacturers who utilize an assembly line method. Customer returns are generated for several reasons including incorrect shipments, late delivery or lack of funds.

Allowances in General

Price concessions may be made for any particular reason depending upon the relationship with the customer. If the customer is willing to accept substitute, damaged or tardy shipments, he or she will usually demand some kind of allowance from the manufacturer. For example, in some cases shipments may be delayed and arrive late. Customers who exert considerable influence may reduce the sales price by a "late" factor.

In another situation a large discount store deducted a 2 percent "defect allowance" for each shipment. Because of the influence large retailers exert, these allowances are rarely, if ever, protested.

Warehouse Allowance

A warehouse allowance is a 2-3 percent discount demanded by many mass merchandisers. It may be accounted for by being indicated as a reduction in price shown directly on the manufacturer's invoice with a reduced net billing or as a chargeback later made by the retailer. The rationale for this allowance, or discount, is that these retailers re-ship to their stores from a central warehouse, enabling the manufacturer to make a single bulk shipment to the warehouse instead of shipping to the individual stores making up the chain. The amount and terms of the allowance are often printed on the purchase order form.

Markdown Allowance

A markdown allowance is generally negotiated with better customers and is based on the likelihood that markdowns from full retail price may need to be taken for the retailer to dispose of some of the shipment. Such an allowance may be demanded as a concession by larger retailers, and if this is the case, the terms may appear on their purchase orders.

Advertising Allowance

An advertising allowance may be allowed the retailer for cooperative advertising. It is usually allowed only to larger retailers with which the manufacturer does a substantial volume of business. The retailer arranges media advertising, catalog, or direct mail promotions featuring the manufacturer's products. The manufacturer's share of the advertising is deducted from amounts otherwise owed to the manufacturer by the retailer.

Yearend Allowance

A yearend allowance is customary with some manufacturers and is usually given only to their best customers, but may also be allowed some of their older customers regardless of volume. The allowance is generally negotiated at an amount usually equal to 1 to 3 percent of annual calendar year sales. The allowance is taken by the retailer as a credit against his or her outstanding accounts payable in the subsequent year. If a $30,000 total allowance is due the customer, the customer will generally take the credit at $10,000 a month over 3 months or $5,000 a month over 6 months either by agreement or as a courtesy to the manufacturer.

Volume Allowance

This is much the same as a yearend allowance but is granted based on annual volume only with a threshold figure set before the allowance of any discount. The discount allowed will generally increase as annual volume passes designated amounts.

Trade Discounts

A traditional trade discount is still demanded by many of the better department stores. The store will account for the purchase at cost before the discount and base their selling price on a markup from this figure. The usual mark up is 100 percent or double cost, sometimes referred to as 50 percent. The practice of doubling cost to arrive at retail price is known as "keystoning." It is interesting to note that many manufacturers will mark up their usual selling price to absorb the trade discount. For example, they will sell the equivalent of $92 in goods to the department store for $100, then allow an $8 trade discount.

Cash Discounts

Discounts are sometimes given by the manufacturer for prompt payment by customers. These discounts may range from 2 to 4 percent depending upon the size and influence of the customer.

Accounting for Returns, Allowances and Discounts

Most manufacturers account for returns and allowances through a normal credit memo system. Whenever a return or discrepancy arises, the taxpayer first verifies the propriety of the return or allowance. For instance, any customer complaints about missing items would be crosschecked with the bills of lading and the shipping invoices. If the claim is valid, a credit memo will be issued to the customer usually to be applied against any subsequent sales.

The credit memos will usually be accounted for using some sort of journal or journal entry. They are normally segregated together depending upon the type of return or allowance and a debit to the related general ledger account is made. The credit then reduces the accounts receivables.

Trade discounts and other discounts such as volume discount are not properly treated as contra-sales accounts but instead should be reduced from invoice price in determining the cost of inventory under Treas. Reg. section 1.471-3(b).

A taxpayer's treatment of trade and other discounts as a contra-sales/income account is an erroneous method of accounting. Any change from such accounting treatment to a proper treatment as a reduction in invoice price is a change in method of accounting requiring the consent of the Commissioner. On the other hand, allowances such as cooperative advertising are not true trade discounts and thus are properly reflected in income accounts.

Likewise, under Treas. Reg. section 1.417-3(b), cash discounts may be reduced from invoice price at the taxpayer's election, providing a consistent course is taken. Again, any change in treatment of cash discounts is a change in method of accounting.

1. **Issues Encountered**

   Issues are not usually raised with actual returns and allowances. However, many issues are generated because the taxpayer will attempt to use a reserve account or estimate the returns and allowances at yearend.

   For financial accounting purposes, reserves for estimated expenses such as returns and allowances or discounts based on past experience, is an approved method of

more accurately stating period income.

Such reserves are generally unallowable for tax accounting purposes. They were abolished for most taxpayers by the Tax Reform Act of 1986 (with the bad debt reserve allowable in certain cases). Reserves for other estimated expenses have been repeatedly disallowed by the courts as not being specifically allowed for by the Code and failing to meet the all events tests for fixing liability.

The use of reserves for financial accounting purposes is found in manufacturing. In some cases there may be a contra account called "Reserve for Returns and Allowances," "Allowance for Cash Discounts," or some other similar title which will be adjusted at yearend as required. A balance sheet reconciliation may show it to be netted with the accounts receivable to arrive at the tax return balance. Journal entries at yearend may then show increases or decreases to the reserve account with a corresponding increase or decrease to the returns or allowances accounts.

If a reserve on the books is used for financial reporting purposes but not for tax purposes, a Schedule M-1 adjustment will be noted in conjunction with a deferred income tax account on the books.

Alternately, adjusting journal entries are prepared at yearend, debiting returns and allowances and crediting receivables directly, without the use of a reserve general ledger account. Such journal entries will be reversed whereas entries adjusting the reserve account will not. If an adjustment is made using this method, a reserve can be readily detected by inspection of the yearend adjusting journal entries and the general ledger accounts. This account will open with a large reversing journal entry and close with one or more large adjusting journal entries. A formidable reserve in the contra (Returns and Allowance) account may open the account with a large credit balance due to the posting of the reversal which is not erased until well into the year or close to yearend.

A variation on the preceding method is to accrue subsequent returns or allowances by totaling credit memos issued in the months following the close of the fiscal year. Those deemed applicable to the prior year's sales are then accrued. Such accruals are of the same nature as a reserve, though they are not based on yearend estimates, but rely on actual figures that are necessarily developed at a later date. The propriety of such accruals is based on the same criteria as is the propriety of any other reserve.

In one case, the taxpayer was following the financial accounting matching concept by accruing for cash discounts anticipated to be taken from the sales made during the last month of the taxable year. This accrual was computed by taking an historical percentage and multiplying against the last month's sales. This is a case where IRC section 461 was applicable and required the use of the all events and economic performance test to determine whether this accrual was allowable for income tax purposes. The examiner disallowed the reserve amount by proposing a IRC section 481 adjustment.

There are many variations on the methods of accounting for reserves. Those outlined above are typical. Knowledge of these formats should enable the examiner to detect the presence of a reserve.

Whatever the reason for the accruals, the permissibility would be determined by applying the "all events" and "reasonable accuracy" tests of Treas. Reg. section 1.446-1(c)(1)(ii) and, if applicable, the "economic performance" test of IRC section 461(h).

TP:
AUDIT ITEM: SALES/GROSS RECEIPTS **DATE:**
FILE NAME: 4000.WPF **INITIAL:**

	YEAR:	W/P REF	YEAR:	W/P REF	YEAR:	W/P REF
P/R:						
P/E:	________		________		________	
ADJ:	=========		==========		=========	

SUMMARY OF ADJUSTMENT: **(SEE W/P:)**

These techniques are not intended to be all-inclusive nor are they mandatory steps to be followed. Judgment should be used in selecting the techniques that apply to each taxpayer.

AUDIT PROCEDURES **W/P REF**

1. Obtain complete explanation of accounting method. If the accounting method is not appropriate, consider Change in Accounting Method. (See GAIN Number 5500)

EVALUATE INTERNAL CONTROLS. (See IRM 4231 Tax Guidelines for IRM Chapter 300)

2. If TP has internal controls for posting of income, select from the following techniques:

   a. Reconcile books to return and analyze yearend AJE to ensure there are no incorrect reductions to income.

   b. Scan sales journal and analyze large or unusual debits to sales (for example, entries from other than CRJ and CDJ). Verify that the sales journal total matches the GL total if the TP's system does not automatically link the two, (that is, if the TP makes a manual entry to record the total from the sales journal).

   c. Test sales recorded in opening days of subsequent year to determine whether said sales are includible in year under examination.

   d. Analyze credit memos on items returned after inventory count and ensure that ending inventory is increased appropriately.

   e. Analyze accounts receivable and identify related trade receivables. Consider forgiveness of debt, IRC section 482 and disguised shareholder loans.

   f. Scan A/R ledger. Make sure credit balances are not used to offset A/R included in income.

SALES/GROSS RECEIPTS (CONTINUED) 4000.WPF **WP REF**

g. Check Liability Accounts for deferred income. Determine if taxable.

3. If TP does not have internal control, and there is potential for diversion of funds, consider the following techniques in addition to those listed in #2.

   a. Inspect controlling Shareholder's return(s) and determine if indirect method is applicable.

   b. Get explanation for difference between bank reconciliation and books. (Cash shortage can be diverted funds to SH.)

   c. Compare cash receipts posted to the CRJ to deposits per bank statement. (An accrual TP can divert payments on A/R to SH.)

   d. Determine the source document for posting income and trace from the source document to the books.

4. If TP does not have reliable double entry books, consider the following techniques:

   a. Inspect controlling Shareholder's return(s) and determine if indirect method is applicable.

   b. Reconstruct income from third parties.

   c. MSSP provides methods of reconstructing income on certain industries.

Chapter 6

INVENTORY

INTRODUCTION

Issues in the examination of inventories range from omission of major segments such as finished goods (FG) and work-in-process (WIP) to recomputation of LIFO pools and indexes.

The purpose of this portion of the manufacturing guide is to provide insight into the more common inventory issues. Therefore complex issues such as LIFO inventory valuations, long term contracts, or standard cost variance analysis will require additional research beyond the scope of this guide.

WHY AUDIT INVENTORIES?

Why audit inventory when all adjustments are "rollovers"?

Despite the potential for tax avoidance inherent in the ending inventory, examiners often perform only a cursory review of ending inventory, with the justification that any adjustment is only a "rollover" adjustment, that is, an increase of taxable income in Year 1 is offset by a corresponding decrease of taxable income in Year 2. This line of reasoning continues, why bother pursuing the issue? Why bother with an adjustment if the net effect is only a timing difference, and therefore, only results in an interest owed effect?

This type of adjustment is typified in the following example. Taxpayer reported the following:

	Year 1	Year 2
Opening Inventory	$ 500,000	$ 750,000
Costs	6,000,000	7,000,000
Ending Inventory	(750,000)	(1,000,000)
Cost of Sales	$ 5,750,000	$ 6,750,000
	44444444444	44444444444

If you found a clerical error resulting in $25,000 being omitted from the ending inventory of Year 1, the potential adjustment would be the following:

	Year 1	Year 2
Opening Inventory	$ 500,000	$ 775,000
Costs	6,000,000	7,000,000
Ending Inventory	(775,000)	(1,000,000)
Cost of Sales	$5,725,000	$6,775,000
	=========	=========

Cost of Sales Adjustment: Year 1 = 5,750,000 - 5,725,000 = 25,000

Cost of Sales Adjustment: Year 2 = 6,750,000 - 6,775,000 = (25,000)

This example illustrates a correction of an error, which includes misstatements of amounts due to mathematical error, computational error, or posting error. These adjustments result in onetime, 1 year rollover audit adjustments. An examiner finding such an error in inventory might decide not to make the adjustment because:

1. The error does not materially distort taxable income

2. The 1 year rollover would not result in a material amount of interest owed by the taxpayer.

On the other hand, an examiner might propose the adjustment if tax rate differences between years result in a significant net increase in tax or if the interest differential is significant.

Another type of inventory audit adjustment is of an entirely different character. It involves IMPROPER METHODS of accounting for various elements in the ending inventory.

Tax literature (including the regulations) goes into great depth discussing accounting methods and changes to these methods where even a simple definition is daunting. To understand a method of accounting as affecting inventory, below are a few examples that relate specifically to garment manufacturers (without addressing the right or wrong of the various methods):

1. Valuing piece goods from prior seasons at a fraction of original cost.

2. Excluding freight-in costs from items in inventory.

3. Excluding sewing contractor costs from work in process.

4. Using a standard cost of 10 cents per unit for such miscellaneous costs of finished goods as plastic bags, hangers, pins, or cardboard.

5. Reducing finished goods quantities by customers' orders which are in hand, but which have not yet been shipped, that is, recorded as sales.

The common element of these method examples are that these practices are followed consistently, routinely and regularly.

So what is the tax effect difference between correcting an error and making a change in accounting method? As seen in the example of the error that was corrected above, errors correct themselves within a specific time period, usually 2 years.

In contrast, because improper methods involve regular and routine accounting practices, the permanent correction will often not take place until you addresses the issue beginning with the return being audited and ending with the most recently filed return. Until the change is made, the taxpayer has the benefit of an indefinite deferral of taxes.

The following example demonstrates that an accounting method change often results in a tax adjustment whose effect is not reversed in the foreseeable future. To highlight this observation, the only variable is the assumption that each year the taxpayer deducted an improper inventory write-down of $200,000. All other factors in the cost of sales equation remain constant.

COST OF SALES AS FILED

	Year 1	Year 2	Year 3	Year 4	Year 5
Beginning Inventory	750,000	750,000	750,000	750,000	750,000
Costs	6,000,000	6,000,000	6,000,000	6,000,000	6,000,000
Inventory	(750,000)	(750,000)	(750,000)	(750,000)	(750,000)
COGS	6,000,000	6,000,000	6,000,000	6,000,000	6,000,000
	=======	=======	=======	========	=======

COST OF SALES AS CORRECTED

	Year 1	Year 2	Year 3	Year 4	Year 5
Beginning Inventory	950,000	950,000	950,000	950,000	950,000
Costs	6,000,000	6,000,000	6,000,000	6,000,000	6,000,000
Ending Inventory	(950,000)	(950,000)	(950,000)	(950,000)	(950,000)
COGS	6,000,000	6,000,000	6,000,000	6,000,000	6,000,000
	========	=======	=======	=======	=======

AUDIT ADJUSTMENTS

	Year 1	Year 2	Year 3	Year 4	Year 5
Beginning Inventory (Curr. Yr. Adjust.)	(200,000)	(200,000)	(200,000)	(200,000)	(200,000)
Ending Inventory (Curr. Yr. Adjust.)	200,000	200,000	200,000	200,000	200,000
IRC 481(a) Adjustment	200,000	n/a	n/a	n/a	n/a
Net Increase to T.I.	200,000	0	0	0	0

In this example, when the size of the inventory understatement is constant from year to year, the deferral the taxpayer enjoys is taken away in the first year of the examination. The taxable income effects are not reversed in the years shown. If the size of the understatement INCREASED from year to year, years 2-5 would reflect net adjustments for the incremental increases. Conversely, if the size of the understatement DECREASED after Year 1, adjustments would be made to reverse the Year 1 adjustment, to the extent of the decrease.

When an incorrect method of accounting for inventory is changed, you are correcting a practice that gives the taxpayer a very long (sometimes indefinite) deferral of income taxes.

These observations should not be construed to mean that all changes of accounting methods in inventory should be pursued. Consider the following to decide whether to pursue an issue:

1. What is the absolute amount of the potential adjustment? Materiality?

2. Is the potential adjustment a significant percentage of taxable income?

3. How long is the deferral period?

4. How substantial is the net interest the taxpayer would owe from the adjustment?

5. Are there examination adjustments other than to inventory?

6. Is the taxpayer consistently making errors with little regard to the correctness of their methods?

In summary, this section presented rudimentary examples to demonstrate that auditing ending inventory should not be dismissed on the assumption that inventory adjustments result in only rollovers. An accounting method change in inventory may take away an essentially permanent deferral, which by itself is a substantial tax benefit. Also, even a one year rollover adjustment may at times be advisable if the adjustment is large enough to result in a significant interest factor, or if tax rate differences between years result in a net increase in tax.

TYPES OF MANUFACTURERS

When auditing inventories, it is very important to know what type of manufacturer is the taxpayer and which costing method the taxpayer uses.

Generally speaking, there are three different types of manufacturers: Custom, Production, and Combination.

Custom

These companies produce goods to customers' specifications. Production and inventory levels are on a job by job basis. Custom companies may or may not have inventory.

Example 1

A company with a fiscal yearend of December 31 produces goods to order and secures materials from local suppliers within a 4 day order window. All work on jobs in process is completed by December 15. The company has contracts for several jobs. However, production will not start for several weeks. Their decision is to shut down the last 2 weeks of the year and begin production on January 3. Thus at December 31, the company has zero raw materials, work-in-process, and finished goods inventory. The company does have a supplies inventory. In this example, the overall amount is immaterial and thus is considered to be zero.

Production

These companies produce goods on a continuing basis. They maintain a specific level of inventory. The companies may produce a catalog (generally bound or in loose leaf form) showing their different product lines and customers place orders from that catalog.

Example 2

A company with a fiscal yearend of December 31 produces office chairs and sells to retail office furniture stores. Based on their experience in the industry, the company keeps a constant level of each current chair style at 300 chairs. Production is geared to maintaining that level of inventory until 2 months prior to the discontinuance of a particular style. Thus if the company has 10 current styles of chairs, they would have at least 3,000 chairs in inventory at December 31.

Combination

Companies who produce goods based on a combination of custom and production as described above.

COSTING METHODS FOR MANUFACTURING

Generally speaking, manufacturers use one of three methods for costing inventory: Job order costing, process costing, and operation costing.

Job Order Costing

Products are readily identified by individual units or batches. These units or batches receive varying inputs of direct materials, direct labor, and indirect costs. Costs are collected according to the job or customer. Examples of job order costing include printing, aircraft manufacture or furniture manufacturing.

Process Costing

Products are homogenous and not particular to any one customer. Production is continuous through a series of production steps. Costs are charged directly to the responsible department or process. Examples of process costing include the manufacture of oil, paint, or rubber.

Operation Costing

Used in the manufacture of goods that have common characteristics plus some individual characteristics. Examples of operation costing include shoes, clothing, or textiles.

INVENTORIES

Treas. Reg. section 1.471-1 states,

"In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods, and in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. * * *"

Cost in the case of merchandise produced by the taxpayer since the beginning of the taxable year is defined by Treas. Reg. section 1.471-3© to include:

"* * * (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, and (3) indirect production costs incident to and necessary for the production of the particular article, including in such indirect production costs an appropriate portion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit. See sections 1.263A-1 and 1.263A-2 for more specific rules regarding the treatment of production costs."

Treas. Reg. section 1.471-11(c)(2)(I)(f) states that the cost of indirect materials and supplies should be included in ending inventory.

Full absorption costing involves two steps on the part of the taxpayer:

1. Costs must be identified
2. Costs must then be allocated between inventory and cost of sales.

The three elements of work-in-process consist of:

1. Direct Materials
2. Direct Labor
3. Indirect Costs.

Treas. Reg. section 1.471-11(b)(2) and (3) defines these elements as:

1. Direct materials are those materials that become an integral part of the finished product, are consumed in the manufacturing process and are identified with specific units or processes.

2. Direct labor is labor which can be associated with particular units. Labor includes basic compensation, overtime pay, vacation and holiday pay, sick leave pay, and

payroll taxes.

3. Indirect costs are those costs necessary for production other than direct production costs. Indirect costs include variable and fixed overhead. They may be classified as to type for identification with various activities and to facilitate groupings for determining unit costs. Under prior law, manufacturers were required to comply with the full absorption rules under Treas. Reg. section 1.471)11. The full absorption rules provided three categories of indirect costs associated with production activities:

   a. Category I are costs includible in inventory for tax purposes regardless of the taxpayer's financial reporting treatment. These include repairs, maintenance, rent, utilities, indirect labor, and production supervisor wages. Treas. Reg. section 1.471-11(c)(2)(I).

   b. Category II are costs that are not required to be included in inventory. These include marketing, advertising, selling and distribution costs, interest, and officers' salaries not related to production. Treas. Reg. section 1.471-11(c)(2)(ii).

   c. Category III are items which must be included or excluded from inventory in accordance with the taxpayer's financial accounting treatment provided such costs are not inconsistent with Generally Accepted Accounting Principles (GAAP). These include officers' salaries performed for production and insurance on production machinery. Treas. Reg. section 1.417-11(c)(2)(iii).

As of December 31, 1986, the Uniform Capitalization Rules remove any option and require that all defined indirect costs be included regardless of financial accounting treatment. See IRC section 263A and the regulations thereunder.

Per Treas. Reg. section 1.471-11, both direct and indirect costs must be taken into account in the computation of inventoriable costs according to the full absorption method of inventory costing.

Under full absorption, costs must be allocated to goods produced during the year whether the goods are sold during the year or in inventory at the end of the year.

AUDITING INVENTORY

There are specific noncompliant areas which indicate audit potential:

1. No physical inventory counts taken. IRC section 471.

2. Failure to inventory overhead cost, direct labor, or both.

3. Failure to implement IRC section 263A (file Form 3115). If the taxpayer properly elected the change, an IRC section 481(a) adjustment should be present on Schedule M)1 through 1991 taxable years.

4. Use of the gross profit method for inventory valuation. This method is specifically not allowed.

5. Use of the cash basis method of accounting.

   If inventories are an income producing factor, Treas. Reg. section 1.446)1(c)(2)(I) requires the use of the accrual method to account for sales and purchases. The fact that yearend inventory values are immaterial does not constitute an exception to the regulation. The significant factor is the materiality of purchases to reported revenues.

   A cash basis taxpayer who has inventory, but does not recognize inventory, faces two potential audit adjustments. An adjustment requiring the recognition of inventories would be proposed under the authority of IRC section 471. The other adjustment mandating the use of the accrual method would be supported by IRC section 446.

6. Comparative Gross Profit percentages are inconsistent. The dollar amount of direct materials costs in finished goods and Work)in)Process (WIP) is high in relation to total inventory (>30 turnover rate is low, there may be very good tax adjustment potential.

See Exhibit 6-1 at the end of the chapter for a list of basic questions to ask when auditing inventory.

See Exhibit 6-2 for an outline of auditing cost of goods.

See Exhibit 6-3 for the GAIN inventory audit workpapers.

General Audit Techniques

1. **Understanding the Production Cycle**

   A solid understanding of the production cycle includes how production is planned, how far in advance raw materials are purchased, how raw materials are prepared for production, the assembly process, the time involved for assembly, the individuals in charge of each process and so on.

2. **Understanding Integration of Accounting System**

The next major step is understanding how production is manifested in the accounting records. This may range from simple purchase entries into the general ledger to more complex journal entries involving a standard cost system. Either way, the major entries must be understood.

Basic production steps such as raw material purchases usually flow through an accounts payable journal and then into the general ledger. Labor is recorded through a payroll journal and again into the general ledger.

Other production steps may involve unique records not generally encountered in the course of a usual audit. For example, production planning or scheduling may be documented by something called scheduling sheets. These sheets may have the planned product lines, materials to be utilized, timetables for each department and inventory identification numbers. These records could be useful in developing work-in-process amounts if omission of these segments becomes an issue.

Some manufacturers not only produce but import as well. Costing of these imports may involve documentation such as letters of credit, brokerage and duties invoices, and customs records. These documents could be very important in determining whether duties, insurance costs, and bank charges have been properly included in inventory.

The more sophisticated companies may use a standard cost system. In this case, it becomes essential to understand how the standard cost entries are integrated into the basic accounting system.

3. **Comparative Analysis**

A comparison of costs over a 2 to 3 year period can highlight many unusual fluctuations. This comparative analysis should be performed as part of a normal package audit step when prior and subsequent years returns become available. The following steps are suggested to produce the most beneficial analysis:

a. Gross Profit Ratios

Comparison of the gross profit ratios over a 3 year period may reveal significant fluctuations. These fluctuations can be due to numerous reasons such as inventory write-downs, cost reclassifications, or simply bad management. Although you may not identify the actual cause of fluctuations immediately, the comparison provides an indication serious analysis may be warranted.

b. Compute the Inventory Turnover Rate

COS / (Beg. Inv. + End. Inv. / 2)

This ratio indicates the number of times a taxpayer's inventory is sold and replenished during a taxable year.

Under FIFO cost flow assumptions, the reciprocal of the turnover rate will be the percentage of current year costs remaining in ending inventory. If the turnover rate is four, 25 percent (1/4) of current production costs would theoretically be in ending inventory. As the turnover rate increases, the percentage of current costs remaining in ending inventory decreases.

c. Compute the $$DOLLAR$$ Percentage (before labor and overhead allocations) of Work)in)Process

(WIP) Materials + Finished Goods (FG) Materials / Total Inventory Materials.

This reflects the percentage of materials started into production and/or materials sitting in finished goods.

If the ratio is relatively small (less than 30 percent), there is less audit potential because cost allocations, (and possible adjustments), are generally made to "in)process" activity.

Another way to analyze this is to compare the dollars in raw materials inventories to the dollars in WIP and FG. If the ratio of Raw Materials (RM) is low compared to WIP + FG, adjustment potential is as favorable. Physical count summary workpapers will be needed for this analysis; however, some workpapers may not provide the dollar amounts.

d. Compute the Number of Days Supply in Inventory

(365 / Inventory Turnover Rate)

This generally measures efficiency. Note that most companies set a "days supply minimum" level to be maintained as managerial policy, providing a good indication of expected inventory levels.

e. Cost to Cost Comparisons

If 3 years of cost comparisons can be performed, it may pinpoint unusual fluctuations. This comparison should include all cost of sale accounts and not just direct costs. For instance, if you notice an unusual increase in indirect labor costs with a decrease in employment taxes, it may indicate the taxpayer has converted employees to independent contractors.

4. Reconciliations

The importance of reconciling the taxpayer's books to the tax return cannot be overemphasized. By reconciling all general ledger accounts, you will gain knowledge of:

a. The mechanics of the accounts, (some credit accounts may be classified with debit accounts and vice versa)

b. The numbering system and how it relates to the specific areas of the tax return (sales may be 400 series, cost of sales 500 series, administrative 600 series and miscellaneous 700 series)

c. Significant dollar accounts which need to be examined as opposed to insignificant accounts which may be passed.

5. **Purchases**

a. Journal Entry Analysis

Before the selection of invoices to test, survey the journal entries which enter into the various purchases accounts. Time should be taken to review the type and pattern of the entries.

For example, the primary entry would probably be generated from an accounts payable or cash disbursement journal and this would be the primary focus of substantiation testwork. Recurring journal entries made in addition to those generated from the normal journals should also be noted. Frequently, these entries represent various accruals, reclassifications, corrections, etc. At this point in time, it is not critical to know the exact nature of each journal entry but rather to recognize the pattern of the recurring entries and what appears to be normal and consistent. By recognizing normal and consistent entries, unusual entries may be highlighted for further analysis.

b. Substantiation Testwork

When invoices are selected for examination, several objectives having a direct or indirect effect on taxable income should be considered before actual testwork is performed.

1) Ordinary and Necessary

The first consideration will always be whether the criteria necessary for a business deduction has been met or whether it is of a personal nature or a capitalizable item.

2) Timing

If the deduction meets the ordinary and necessary criteria, does it relate to the current year or a subsequent year? In years of tax rate increases this should always be a consideration. Test check purchases accrued at yearend. Problems are mostly encountered with smaller closely held companies that do not have accounting controls. Accountants usually assume bookkeepers who prepare yearend accruals know how to perform cut-off testwork. This is not always the case.

Also, determine if any credit memos are outstanding at yearend for returned purchases. These credit memos will be applied to the subsequent years purchases thereby producing an acceleration of deductions.

3) Allocations

An expense may meet the above criteria but may be incorrectly classified. For instance sales commissions may be improperly booked as an indirect production cost. Depending upon the magnitude, this may have a significant effect on certain allocation formulas used in the IRC section 263A regulations.

4) Confirmations

Purchases testwork can provide evidence as to whether the taxpayer is properly counting and pricing ending inventory.

a) Test large dollar purchases at yearend. Compare the purchases with yearend inventory records. If a production cycle takes 3 weeks, purchases made in the last 2 weeks or so should be included in either raw materials or work-in-process. When this test is applied, comparisons may be made either with quantities and/or dollar amounts.

b) Select a variety of vendors to examine. This gives ranges of materials and prices.

5) Substance

Although not encountered often, some cases did involve related entities engaging in transactions between themselves. Issues to be aware of include: pricing in excess of fair market value, excessive allowances, and the possibility goods and services were never delivered. The possibility of false invoices fraudulently inflating purchases should not be precluded. If questionable transactions are suspected, you must consider the possibility of auditing the related entity to determine the propriety of the transactions.

6. Cost of Labor

The issues related to the labor portion of cost of sales do not usually involve substantiation issues. If not overly complex, a payroll reconciliation between employment tax returns and the corporate or partnership return may prove sufficient. A reconciliation should include wages and salaries as well as employment taxes deducted on the return. Reconciliations may raise independent contractor versus employee issues. Other issues may involve proper accruals for vacation and sick pay.

a. Journal Entry Analysis

Larger companies often accrue for vacation and sick pay. The accounting treatment is usually different for tax and book. As of 1988, the rules for accrual of vacation and sick pay have changed. Deductions for vacation and sick pay are limited to the amounts paid during the tax year, except an accrual-basis taxpayer may deduct unpaid vested vacation and sick leave pay if paid to the employee within 2 ½ months after the end of the year. IRC section 404(a)(5) and Treas. Reg. section 1.404(b)-1T, Q & A.

For vacation pay to be deductible under IRC section 461, it must meet the All Events Test as well as the Economic Performance Test. For instance, for a company to deduct accrued vacation pay, economic performance must be established by: (1) the employees providing the services and (2) a liability must be established meaning the employee should be vested in the plan. If an employee does not meet the vesting requirements, no accrual may be deducted.

Since there are differences in the accounting treatment between book and tax, an adjustment should be present on the M-1 reconciliation schedule. `If no such adjustment exists, analyze any vacation pay accruals. The following steps are suggested but by no means represent the only audit steps possible:

1) Determine basis for accrual per books. This can be based on a sophisticated formula, a simple estimate, or if the books are kept open long enough, the actual vacation/sick pay for the subsequent 2 ½ months.

2) Request the company's policy on vacation/sick pay accrual. Determine how many years an employee must work for the company before vacation/sick pay has vested. Determine the basis for computation. It is usually based on number of hours worked during the year.

3) Check Year End Journal Entry. If the accrual seems unusual, test the subsequent 2 ½ month's payroll records for the vacation pay entries. Any large differences between the actual payment versus the accrual should raise questions about the propriety of the accrual.

b. Allocation of Production vs. Non-Production Costs

In cases where corporate officers are earning large salaries, determine the primary duties of the officers (that is, sales, administrative, production, combination). This may be important in regards to the IRC section 263A allocation. If an officer's salary is primarily related to a single function, it can have significant impact on an allocation formula, especially the simplified production method. Significant in small companies where officers' duties are multi)functional, taxpayers fail to recognize the mixed service cost portions for IRC section 263A purposes.

7. **Other Costs and Deductions**

Other costs and deductions usually involve production expenses such as indirect labor, rent, insurance, and other variable or fixed overhead costs. The same audit techniques applied to the purchases would also apply to Other Costs and Deductions.

The following steps are recommended to begin the examination of inventory:

1. **Determine How the Inventory Amount Was Calculated**

   One of the first initial interview questions regarding inventory should be whether the taxpayer took a physical inventory. The second question should be whether the taxpayer actually counted the items on hand. In several cases, taxpayers inspect their inventory but estimate either the actual quantities on hand or the relative dollar amounts. Although the experience of the taxpayer may allow him or her to do this accurately, you may need to expand the scope of testwork to verify this. Under Treas. Reg. section 1.471-2(d), a taxpayer must verify inventory annually if on the perpetual method of accounting.

2. **Determine All Possible Locations of Inventory**

   During the initial interview and tour of the business, notate all possible locations of inventory. This includes additional warehouses, showrooms both on and off the premises, and additional factories. If the taxpayer operates a company outside the United States, this location should also be considered as an inventory site.

3. **Obtain Ending Inventory Records**

   If possible, obtain all pertinent inventory records. This includes:

   a. Inventory Summary Sheets

      These show totals for general categories such as raw materials, work-in-process, finished goods, goods-in-transit, and goods-on-consignment Once records have been obtained, foot the schedules and reconcile the total to the return. If the total does not reconcile, determine the reasons. Possibilities may include market write-downs, IRC section 263A additions, errors, etc.

   b. Physical Count Sheets

      These can be voluminous, depending upon the size of the inventory. Obtain a complete set if possible. These records are very important because they provide information regarding specific types of raw materials, actual counts, pricing, and product lines.

Note the following:

1) Crossed out values being replaced with lower or zero valuations.

2) The delineation of raw materials, work in process and finished goods (additional overhead costs will be allocated to WIP and finished goods).

3) How parts or items are identified on the worksheet.

4) The basis for determining unit costs (at actual or standard).

5) That the totals foot. Summarize and reconcile with ending inventory balance per book. Check these records for mathematical accuracy on a sample basis by footing and extending.

6) Any items with unusual and low priced values ($10.00 when other items are priced with odd figures such as $105.45).

b. Cost Sheets

These may be requested (if available) if valuation issues arise such as proper use of the full absorption method, IRC section 263A or lower of cost or market method. Potential information includes breakdowns of particular goods or product lines in terms of raw materials (type, quantity, and cost), labor (hours per item, rates per hour, total dollar per item) and any overhead allocations (specific costs, overhead rates).

In reviewing overhead allocations for WIP and finished goods, ascertain that:

1. Appropriate inventory costs are considered, and ALL applicable inventory costs are included

2. Basis for allocating or burdening the costs to inventories (dollars, hours, units, square footage) is appropriate

3. Computations are correct and consistent from year to year.

d. Burden Computations/263A UNICAP Computations

These will probably be provided by the accountant and could show costs used in the allocation and methods used for allocation to ending inventory.

4. **Journal Entry Analysis**

   In many cases, general ledger inventory accounts will not have much activity during the year. Analyze any yearend journal entries which reduce inventory and increase cost of sales. In one case, an inventory write-down was made in this fashion.

5. **Reserves**

   In some cases, taxpayers reduce the value of their inventory through the use of reserves. While this is acceptable for financial accounting purposes, it is not acceptable for tax purposes. If a reserve account is encountered in the accounts of inventory, there should be a Schedule M-1 adjustment for the current year change to the reserve accounts.

ISSUES

Inventory issues generally fall into two primary categories:

1. Incorrect inventory counts/omissions
2. Improper valuations.

Identification and development of these issues directly depends on the existence and quality of the inventory records. Identification of issues may not be very difficult (taxpayer tells the examiner they estimate their final inventory). Development (figuring out what inventory dollar amount is reasonable) can require ingenuity, creativity, and plain sweat to finally resolve the issue.

Incorrect Inventory Counts and Omissions

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

1. **Purchases**

   In most cases raw materials are purchased locally and can be delivered in a matter of days or even hours. In some cases, raw materials may be purchased from foreign countries and take several weeks for delivery. Taxpayers will often not include these goods in their physical counts. In other cases, the taxpayer will forget to count certain items.

"Phony" purchases should not be dismissed automatically, regardless of how unlikely they may seem. One case involved payments for merchandise that were documented by invoices and canceled checks. The manufacturer arranged for a seller to provide invoices for merchandise which would be paid in the same manner as bona fide purchases. The seller negotiated the checks and returned the cash to the manufacturer (less a fee), outside of the manufacturer's books. If you sampled purchases that included phony ones, you would be presented with an invoice as well as proof of payment for the bogus amounts.

A second scheme was perpetrated by outsiders against a manufacturer, but with the help of a key manufacturing employee, the controller. The outsiders operated in the form of numerous fictitious suppliers that billed the manufacturer for a variety of merchandise. Payment of these invoices was authorized by the dishonest controller. While the tax effects of this arrangement would be a timing difference (disallowance in the initial year; theft deduction in the year of discovery), the boldness of the plan and its ingenuity warrant mention.

Improper purchase accruals, based on phony invoices, have also been detected. In that case, the taxpayer did not contest the finding that the invoices were illegitimate, but instead, contended that the ending inventory included the goods in question, so that there was no net tax effect. Subsequent evaluation of taxpayer's position found that the ending inventory did include some of the "phantom goods."

Of a less serious nature than phony invoices, but which would also provide a tax benefit, is the practice of including subsequent year purchases in the ending accrual when the goods in question are not also inventoried. Though this would only provide a timing benefit, it could result in a long term deferral if it occurs every year.

A final observation concerning purchases involves yearend goods in transit, their deduction as part of purchases and their exclusion from the final inventory. The reason for this inconsistency is that the inventory count is often done by production or warehouse personnel, based on what they see. On the other hand, the accounting for purchases is based on documents that follow a systematic processing route, and are much less likely to be overlooked. Unless this discrepancy is corrected in the audit, the manufacturer would receive an accelerated deduction for the amount that was not inventoried.

2. **Finished Goods Imported from Overseas**

Payments are usually made via letters of credit and delivery often takes several weeks. These goods-in-transit may be excluded at yearend.

3. **Goods on Consignment/Sample Pieces**

   Goods are often held by sales representatives on consignment. Showrooms often house large selections of inventory for public or commercial viewing. Sometimes these pieces are neglected in the inventory count.

4. **Return Items**

   Yearend journal entries often include accruals for approved "returns" which are not yet in possession of the manufacturer.

   If a dispute arises with a customer which can only be resolved by returning the goods to the taxpayer, these goods should be added back to inventory.

5. **Work-in-process/Finished Goods not Counted**

   In some cases the taxpayer does not include work-in-process and finished goods in the ending inventory count. They mistakenly believe fast turnaround times for completion, delivery and entry into sales do not require them to count the goods as inventory. In addition, taxpayers may exclude certain cost centers (departments).

6. **Material Supplies**

   Miscellaneous supplies, while not significant alone, can become a substantial dollar amount when combined. These items may be excluded from ending inventory if they are believed to be incidental or "too hard to count."

   Example 3

   In the furniture manufacturing industry, items such as wood legs and arm pieces, veneer pieces, nails, staples, and other incidental supplies were not included in ending inventory.

7. **Audit Techniques - Incorrect Inventory Counts and Omissions**

   a. Footings and Extensions

      This step is included as a reminder because the findings of one case reinforced the importance of verifying this clerical procedure. A medium sized manufacturer, organized with many formal accounting guidelines, used prenumbered inventory count sheets to take the inventory. All items were carefully combined into detail sheets. However, not until the company's internal audit testing was conducted were the footing errors identified. They occurred on several detail sheets, and the errors total was over $1.5 million.

Reconcile the tax return figures to the trial balance. Trace the trial balance amounts to the general ledger. Reconcile the beginning and ending inventory balances to the respective prior and subsequent years tax returns.

Verify that the method of valuing inventory actually used is the same as the method indicated on the tax return. If there is a difference, ask questions to determine the reason for the difference.

Examiners sometimes limit their inventory audit to testing the footings and extensions of taxpayer's inventory sheets. This is a first step, but it should by no means be the scope of the inventory review.

b. Nonexistent Purchases

Since nonexistent purchases are often evidenced by phony invoices, and sometimes by canceled checks, how can you distinguish them from proper ones? There is no one key to identifying such arrangements. However, comparisons with legitimate purchases would likely reveal differences in one or more of the following areas:

1) Unusual endorsement on checks, such as the name of the endorser, or location of the bank negotiating the check, or cashing of the check by a check cashing business.

2) Unusual supplier or payee name. Names of many established suppliers will become familiar to you during the audit.

3) Appearance of the invoice is unusual as to the type of goods, quantities, payment terms, prices, or signature of receipt acknowledgment.

4) Absence of usual attachments to the invoices. Most manufacturers' accounting procedures include attaching the following types of documents to the purchase invoices: purchase order, packing slip, shipping documents, receiving verification, and customs documents.

c. Yearend Cut-Offs

Checking cutoffs is easily included as part of normal sampling, and takes little additional time.

When sampling purchases accounts, selecting transactions from the last months of the year and from the ending accruals can serve two audit purposes:

1) Determining the potential adjustment in a purchases sample

2) Examining inventory.

The closer to the end of the year that a purchase is made, the more likely that it would still be separately identifiable in the inventory records at yearend.

This sampling can be performed in conjunction with the purchases testwork. Select some of the major purchases made at the end of the year for raw materials. If the production cycle is documented, delivery times for raw materials should be one of the questions. Know the time it takes for receipt of materials, the cycle of the production process, and final conversion into finished goods.

Compare major purchase invoices with physical count sheets for the raw materials. In some cases, material may be directly traceable due to similar descriptions on the invoice and count sheets. In other cases you may need to use all factors such as material quantity, description and dollar amounts, both price per unit and total dollar to determine whether a particular purchase was included in the count.

Example 4

In the furniture manufacturing industry, items such as lumber, fabric, and foam are primary purchases for upholstered goods. Lumber is usually measured by foot or meter dimensions such as 2 ½ x 8 ½ and is priced in terms of board feet/meters. Foam is also described in terms of dimension but is sometimes priced by either dimensions or weight. Fabric is measured in terms of yardage and is priced accordingly. Use of all these factors may be necessary to reconcile invoices with the count sheets.

c. Letter of Credit (LC) Analysis

Purchases made from outside the United States may have an LC arrangement made with a domestic bank to arrange a transfer of funds to the overseas vendor. A letter of credit is simply a short term loan against an established line of credit.

Example 5

Although it is highly probable purchases made overseas are handled differently than the following narrative, it is discussed as it appears frequently.

Title will vest to the purchaser depending upon the specific arrangement with the overseas agent and is based upon who accepts risk of loss or damage during shipping. In some cases the purchaser will accept the risk when the goods

leave the vendor (FOB Origination) or when the goods have reached the domestic port (FOB Destination). It is up to you to determine each individual case. Each specific purchase of inventory is usually designated as a "container" and an LC is set up separately for each container. Each LC is identifiable by a specific number provided by the domestic bank handling the transaction.

The LC will normally appear with the short term notes payables section of the balance sheet. If possible, obtain a breakdown of the LC and request documentation such as the brokerage statements behind each LC. Once the information has been obtained, compare the LC which was booked into purchases with the inventory records to determine whether it was included.

d. Goods on Consignment/Sales Samples

Identification of issues may be accomplished with a simple initial interview question regarding showrooms and locations along with the existence of show pieces and then a comparison with the ending inventory records.

f. Returned Items

Check the yearend journal entries for accruals of approved returns which may not be in the possession of the manufacturer. If they are proper accruals, they should be included in inventory at their respective cost.

g. Omitted WIP/FG

If these segments are missing, computation of reasonable amounts can be performed with sufficient information.

Example 6

During the initial interview, the taxpayer stated a sale will be recorded when goods have been shipped and acknowledged with a customer signature on the bill of lading. Technically speaking, the auditor can then look at the subsequent years sales along with the bills of lading and determine which goods were shipped before or on the last day of the year. The goods shipped should appear in finished goods inventory, or be traceable to work in process inventory at the end of the year. To perform this test, sales invoices are required, as well as documentation of goods completed and returned during the interim period. This will establish the number of units.

How does the auditor establish a dollar figure?

At this point it is up to the creativity of the examiner to arrive at a reasonable number. The number should be based on information gathered from the taxpayer about the company if possible.

For example, in the initial interview the shareholder has stated he tries for a 100 percent mark-up on cost. Therefore, the cost is estimated to be 50 percent of sales price. Take the total sales price of the above estimated units and multiply by 50 percent. This gives you a starting inventory number for finished goods.

Or once you has determined the correct quantities and styles for finished goods, you can verify the costs that should be included by reference to the cost sheets for the applicable styles. All costs listed on a cost sheet should be included for inventory purposes.

In some cases, taxpayers may be willing to take a current physical inventory. Of course a current physical inventory has no bearing on the accuracy of the cost of sales for the year of audit due to the 2 or 3 year time lag. However, having an accurate physical count provides basis for computation of a true gross profit percentage using current year information. This may allow the examiner to extrapolate the percentage back to the years of audit if factors are reasonably similar.

h. Incidental Supplies

Although manufacturers often include the value of the incidental supplies in the costing of their finished goods, they do not always include the supplies still available at year end in the physical count.

A means of estimating the portion that should be inventoried separately is to make an assumption that the incidental supplies remain in ending inventory in the same proportion major materials (lumber, foams, fabrics, etc.) bear to the total purchases of major materials during the year. The formula can then be applied as follows:

$$\frac{\text{Ending inventory major materials}}{\text{Total purchases of major materials}} = N\%$$

N% x total incidental supplies = ending incidental supplies to be inventoried

Improper Valuations

1. **No Freight Addition to Raw Materials**

Treas. Reg. section 1.471-3 states inventories t cost should include the invoice price of such goods less trade or other discounts, plus transportation or other necessary charges incurred in acquiring possession of the goods. The

materiality of this addition depends upon where the raw materials are obtained and how much effort is required to deliver the materials.

2. **Imported Goods**

Costs incurred to import from overseas include:

a) Letter of Credit Charge

This is the actual cost of the goods.

b) Letter of Credit Processing Fees

Cost of setting up letter of credit, wire transfers, etc.

c) Shipping Freight Charges and Import Duties

d) Insurance Costs

Although these costs vary, it is safe to say costs incurred to bring the goods from overseas range between 6 to 10 percent of the letter of credit charges. When you encounter imported goods, be aware of these additional charges for inventory purposes.

Inventory Write-Down under the Lower of Cost or Market Method

Write-downs are taken in several ways:

1. The inventory total on the inventory summary page may be followed by an amount by which the total is being reduced. This is usually a percentage factor or a nonspecific "round" number.

2. Specific items may be written down. One method is to cross through selected cost figures on the detail sheets and substitute lower amounts. Another method is to list the written down amount as the cost figure on the detail sheet for any items that the manufacturer wishes to write-down. Write-downs from this second method would be found via unit cost testing.

3. The most difficult write-down to locate in the audit is that which is taken by completely omitting the item from the count and detail sheets. By doing so, the manufacturer is taking the position that the items are being written down to a zero value, but the manufacturer who uses this method is obviously being more secretive.

Taxpayers explain their write-downs several ways:

a. A common explanation given for write-downs is that the manufacturer values his or her inventory at the lower of cost or market, and for the items written down, the market was lower.

b. Another justification for markdowns is the manufacturer's many years in the industry, which is the basis for knowing that the value of certain goods is less than their original cost.

c. Other manufacturers justify their write-downs by reference to a desire to maintain a stable gross profit percentage. They reason that certain items are no longer "fashionable" or "hot." Therefore, any products made with these items will command lower prices. If they write down these materials now, the lower costs attributable to these units will be matched with the lower prices that will be realized on sales to the customers. Therefore, the gross profit will remain the same, and income will not be distorted. With this explanation the taxpayer ignores the distortion to taxable income in the year that the write-down is deducted.

Each of these explanations makes an appeal which sounds logical. However, none follows the Service's position with regard to allowable write-downs. Part of the reason for the wide noncompliance in this area is that the Code and regulations by themselves do not provide a comprehensive list of rules at one citation. For example:

-- IRC section 446(b) states that a method of accounting must "clearly reflect income."

-- IRC section 471 directs that inventories both conform to the best accounting practice in the trade or business and clearly reflect income.

-- Treas. Reg. section 1.471-2(c) presents the "bona fide selling price" and "30 day" criteria of valuing subnormal goods.

-- Treas. Reg. section 1.471-4(a) states that in the case of inventories valued at the lower of cost or market, "market" means current bid price.

A clearer, more comprehensive statement of the Service's position about inventory write-down guidelines can be gleaned from the ***Thor Power Tool v. Commissioner***, 79-1 USTC ¶ 9139. Although the fact pattern of ***Thor*** is very different from that which will be found in all manufacturing cases, the real value of the case lies in its outline of the requirements for proper tax write-downs. Its comments included the following observations:

1. Write downs which are obviously inconsistent with the regulations do not "clearly reflect income," and the Commissioner acts within his discretionary power in reaching this conclusion.

2. Taxpayer must value inventory for tax purposes at cost unless "market" is lower.

3. "Market" means "current bid price," which in turn means "replacement cost, that is, the price the taxpayer would have to pay on the open market to purchase or reproduce the inventory items."

4. Taxpayer is permitted to value inventory below replacement cost ("market") only when:

   a. Merchandise is offered for sale at prices below replacement cost

   b. Merchandise is "defective," as described in Treas. Reg. section 1.472-2(c). In the latter situation, the taxpayer would still have to demonstrate actual offerings of goods at below replacement cost. These offerings would have to have been made no later than 30 days after the inventory date.

5. It is appropriate that the burden of proof rests with the taxpayer. It is also appropriate that the taxpayer bear this burden via "hard evidence," that is, documentation of sales at the below replacement cost rates.

With these requirements in mind, one can more easily evaluate the technical strength of the manufacturers' justifications for write-downs.

1. The first invokes the "lower of cost or market" phrase, but the interpretation that manufacturers give "market" is very different from the tax meaning of the word. Manufacturers equate "market" with the price at which they think they could resell the materials. For tax purposes, "market" means replacement/reproduction cost, WHICH USUALLY APPROXIMATES OR EVEN EXCEEDS COST.

2. The second justification, years of experience, is even easier to address, since manufacturers who use this rationale have not borne any of their burden of proof. Obviously, "years of experience" is not the hard evidence envisioned by ***Thor***.

3. Maintenance of the gross profit percentage is an explanation that also attempts to persuade by incorporating key words. However, the write-down guidelines still require a comparison of cost versus replacement cost versus documentation of actual sales or offerings. These "tests" have nothing to do with the manufacturer's desire to show consistent gross profit percentages.

Rule of Law: Treas. Reg. section 1.471-4 provides the rules that govern when inventory may be reduced to the lower of cost or market. The most significant guidelines of the regulation are:

1. "Market" means the current bid price prevailing at the date of inventory for the particular merchandise in the volume which is usually purchased by the taxpayer. This rule applies to both finished goods as well as raw materials. The "current bid price" has usually been defined by the courts as the replacement cost of the goods. See ***Thor Power Tool Co. v. Commissioner.***

2. Where no open market exists or where quotations are nominal, the taxpayer must use such evidence of a fair market price at the date or dates nearest the physical inventory count. This means the taxpayer should provide evidence such as a sale of the particular or similar item or show the item was placed on the market at a lower price than cost. If this burden has been met, the taxpayer may value the specific inventory item at the lower price less any costs of disposition. The correct prices are determined by reference to actual sales for a reasonable period before and after the date of inventory.

3. When the lower of cost or market method is applied, the market value of each ARTICLE on hand at the inventory date shall be compared with the cost of the ARTICLE. The lower of such values shall be taken as the inventory value of the ARTICLE. Therefore, this rule precludes a manufacturer from taking a general write-down on a combination of raw materials as well as finished goods, or on several different lines without providing evidence of the fair market value for each specific item.

Audit Techniques - Improper Valuations

1. **Freight Valuations on Raw Materials**

Evaluate the inventory summary and determine if any freight additions have been made via a percentage mark-up. Taxpayers often simplify computations with a general percentage addition to the entire raw material amount.

If no such mark-up exists, a comparison can be made between selected purchase invoices and the physical count sheets. Freight costs vary significantly depending upon vendor location.

Review the delivery documents. These include shipping documents and bills of lading, packing lists describing the number of units and shipping weight, and delivery slips indicating the date of delivery. Receiving documents will contain data regarding the number of and type of units received and the receipt date if it

has not already been stamped on the related invoice. The manufacturer's description of the goods received may differ from that shown on the supplier's invoice and should be noted for purposes of inventory identification. These documents are usually associated with the related purchase invoice.

2. **Imported Goods**

Obtain the back-up documentation behind a specific Letter of Credit (Custom Statements, Brokerage Statements, Duty Statements, etc.). Make an analytical comparison with the count sheets for any imported goods. Because of fluctuations in currency rates, the various costs may change but an average percentage mark-up for each container can be computed and applied to the imported goods inventory. The recomputed costs can then be compared with inventory records.

3. **Inventory Write-Downs**

Write-downs of inventory may be found anywhere ranging from the detailed inventory records to the accountant's trial balances. Therefore the auditor should be aware of the following:

a. Obtain and review the inventory summaries which contain the totals for raw materials, work-in-process and finished goods. Many times a write down shows up as a single entry at the bottom of the inventory category as a percentage or dollar reduction.

b. Be aware of selected categories of inventory items. For example, finished goods may be categorized by location in the plant of the manufacturer or in a separate warehouse. The goods at the warehouse may be hard to sell items whose value has been decreased.

c. On the detailed inventory records which show the counts, prices and extension, be aware of prices having been crossed out and replaced with lower values. Check goods valued at even prices and those appearing to be significantly lower than other similar items.

Example 7

A newer line of sofas is valued at $173.78 per item. Another line may be valued at $100 or lower. This may indicate a write down was taken in a previous year.

d. If the taxpayer has kept old price lists related to the year of audit, request these lists. Although they will probably be the wholesale or retail prices and not cost, they may provide a comparison of relative value if the taxpayer uses consistent mark-ups.

e. If the taxpayer has a showroom, determine if these items have been included in the inventory count or valued at significantly lower amounts than normal.

f. Manufacturers may have physical counts of goods with zero values. Question the reasoning behind these values.

4. **Cash Basis Taxpayer With No Ending Inventory**

Gross Profit Mark-up Method -- The following example shows a change in accounting method from cash to accrual where no ending inventory records were kept. By following this, the examiner can determine a reasonable ending inventory for the taxpayer.

Sales per return	$931,406
Add: Accounts Receivables	54,010
Equals: Sales per exam	$985,416
Multiplied: Cost (100% -20% *)	80%
Equals: Cost of Sales	$788,333
	=======
Purchases per return	$879,056
Add: Accounts Payables	47,179
Equals: Goods Available for Sale	$926,235
	=======
Cost of Purchases	$926,235
Less: Cost of Sales	788,333
Equals: Ending Inventory	$137,902
	=======

*Use the gross profit percentage in the industry.

STANDARD COST VARIANCE TREATMENT

Many of the large companies use standard price costing and perpetual inventory cost accounting systems. This may confuse some examiners. The key here is to audit the valuation and treatment of variances (standard to actual).

Under the standard cost method, engineering analysis and other costing techniques are used to project the cost of a particular item. These projections are generally made for both direct and indirect production costs. When using the standard cost method, variance accounts are used by the taxpayer to record differences between a standard cost and the actual cost.

The variances can be recorded at the date of purchase, different stages of production, and when goods are transferred from work)in)process to finished goods or back to

materials as a sub)assembly. The variance accounts will usually be located in the cost of sales section of the general ledger. The general ledger will show the entries into the variance account. Descriptions and detail of the entries are usually located with the journal vouchers. There are many different variances that can be developed by a company. Some of the more common variances are the following:

-- Material variances can be due to the difference between the standard and actual cost of the part (price variance) or the amount of material actually used (usage variance).

-- Labor variances can be due to differences in labor costs which are due to number of hours worked (efficiency variance) or the wage rate paid (rate variance).

-- Overhead variances can be due to the difference between the amount of overhead applied to production at a predetermined standard rate and the amount of overhead actually incurred.

It should be kept in mind that standard costs are often based on estimates, averages and data collected over a period of time. For this reason, standard costs are often difficult and time consuming to verify.

However, some audit techniques can be used early in the examination process to determine if a more in)depth investigation is needed. The following are some audit techniques that may be helpful to ensure that ending inventory approximates actual costs:

1. Sample parts in the raw materials ending inventory. Compare their standard cost to an actual purchase invoice for similar parts at yearend.

2. Standard direct labor rates for production departments are usually based on the average wage paid within each department. Verification of the wage rates used to compute the average wage in a department can be found in the employee payroll files.

3. Look at yearend for large unfavorable variance account balances. Per Treas. Reg. section 1.263A)1(f)(3)(ii)(B), a taxpayer must allocate a pro)rata portion of any overhead variance and any direct production cost variance to ending inventory. The regulations allow variances to be deducted currently if the following three conditions are met:

    a. Variances are not significant in amount in relation to the taxpayer's total actual indirect production costs for the year (regulations do not define significant).

b. The taxpayer must deduct the variance in their financial reports.

c. Both positive and negative variances must be treated consistently.

4. Check to see how often the standard costs are updated. If the taxpayer has revised the standard costs based on the most current costs, then there may be no need to allocate any portion to ending inventory. However, large unfavorable entries at or near yearend should be investigated to determine if they are the result of rework labor, scrap, or spoilage. IRC section 263A requires such costs to be capitalized.

   The taxpayer must reallocate to ending inventory a pro rata portion of any net negative or positive overhead variances and any net negative or positive direct production variances.

   Treas. Reg. section 1.263A-1(f)(3)(ii)(B), which provides as follows:

   > *** * * Net positive overhead variance means the excess of the total standard indirect costs over total actual indirect costs and net negative overhead variance means the excess of total actual indirect costs over total standard indirect costs. The proper use of a standard cost method requires that a taxpayer must reallocate to property a pro rata portion of any net negative or net positive overhead variances and any net negative or net positive direct cost variances. The taxpayer must apportion such variances to or among the property to which the costs are allocable. However, if such variances are not significant in amount relative to the taxpayer's total indirect costs incurred with respect to production and resale activities for the year, such variances need not be allocated to proper produced or property acquired for resale unless such allocation is made in the taxpayer's financial reports. A taxpayer must treat both positive and negative variances consistently.**

The ratio is computed as follows:

$$\frac{\text{Total Direct and Indirect Variances}}{\text{Total Actual Indirect Costs}}$$

Following are three examples (Examples 8, 9, 10) of standard cost variances:

<u>Example 8</u>

Determining the Significance of a Variance

	Standard Costs	Actual Costs	Variance
Direct Materials	10,000,000	12,000,000	**2,000,000**
Direct Labor	14,000,000	10,000,000	**(4,000,000)**
Overhead	42,000,000	45,000,000	3,000,000
Total	66,000,000	67,000,000	1,000,000

Significance Ratio:

$$\frac{\mathbf{2{,}000{,}000 + (4{,}000{,}000) + 3{,}000{,}000}}{\mathbf{45{,}000{,}000}} = \mathbf{2.2\%}$$

<u>Example 9</u>

Calculating a Standard Labor Cost Variance

The following example was based on these factors:

a. Management's determination of the hours required at reasonable efficiency to manufacture a widget

b. The average hourly rate for the skills required

c. Standards for direct materials are based on the normal price for materials and the normal quantities consumed in producing the product.

Standard direct labor cost assigned per widget:
1/120 hour x $3.60 per hr. = $.03 per widget

During the year 10,000,000 widgets were produced.

Standard direct labor cost of total widgets produced:
10,000,000 X 1/120 hour x $3.60 per hr. = $300,000
or
10,000,000 X $.03 per widget = $300,000

Actual direct labor cost of total widgets produced:
10,000,000 x 1/100 hour x $4.00 per hr. = $400,000

Standard direct labor	=	$300,000
Actual direct labor	=	$400,000
Direct labor cost variance	=	$100,000
		========

Example 10

Standard Cost Comprehensive Example

When unit standard cost rates have been developed for a product, the product may be priced and the inventory valued based on these standard costs rather than actual costs.

Standard Cost per Unit of Product A:

Direct Materials - 3 lbs. @ $1.00/lb.	=	$3.00
Direct Labor - 10 Minutes @ $3.00/hr.	=	.50
Total Standard Direct Cost		**3.50**
Variable Overhead - 10 Minutes @ $2.40/hr.	=	.40
Fixed Overhead - 10 Minutes @ $2.10/hr.	=	.35
Total Standard Cost per Unit		**$4.25**

Units in Ending Inventory = 10,000
Units Produced = 100,000

Ending Inventory Valued at Standard (10,000 @ 4.25)	=	**$42,500**
		=======

Actual Costs:

Direct Materials	=	$410,000
Direct Labor	=	70,000
Total Actual Direct Cost	**=**	**$480,000**
Total Standard Direct Cost (100,000 units at $3.50/unit)	=	$350,000
Direct Cost Variance	=	**$130,000**
		========
Variable Overhead	=	$35,000
Fixed Overhead	=	$30,000
Total Actual Overhead Cost	=	$65,000
Total Standard Overhead Cost (100,000 units @ $.75/unit)	=	$75,000
Overhead Cost Variance	**=**	**$(10,000)**
		========

Ending Inventory:

10,000 units @ $4.25 Standard Cost per Unit	=	$42,500
Allocation of **Direct Cost Variance** to Ending Inventory (10,000/100,000 units x (130,000))	=	13,000
Allocation of **Overhead Cost Variance** to Ending Inventory (10,000/100,000 units x (10,000))	=	(1,000)
Ending Inventory Value	=	$54,500

OTHER CONSIDERATIONS

Practical Capacity

Fixed indirect costs can be allocated based on the practical capacity method. IRC section 263A repealed the practical capacity method of allocating fixed indirect costs. However if the taxpayer wishes to adopt the practical capacity method and was already using it at the time the full absorption regulations were adopted, there is no special election to follow. If taxpayers seek to change to the practical capacity method, the National Office conditions the consent only if the taxpayer uses the same method for financial reporting purposes.

Idle Capacity

Treas. Reg. section 1.263A deals with idle capacity. If an asset is temporarily idle, the only costs that are excludable from inventoriable costs are depreciation and rent on leased equipment. Idle capacity does not mean:

1. The equipment that is being used at a lower rate than when the equipment is fully utilized.

2. Equipment that is en route to a job site.

3. Equipment that is used only during certain shifts.

The entire asset must be idle for a finite period, that is, 2 weeks.

LIFO Inventory Valuation

A complete explanation of LIFO methods would involve an entire manual. It is suggested if a LIFO method is encountered, obtain IRS training guides (Training guide 3127-001, LIFO Method of Inventory Valuation, Rev. 12-87) or other supplemental manuals. A few steps might be performed while researching the issue:

1. **Taxpayer Must Make a Proper Election**

   Whenever the taxpayer utilizes the LIFO method per IRC section 472, a proper election must be attached to the return for the year the LIFO method is first elected. The application may be made on the Form 970 or on a separate schedule prepared by the taxpayer which provides the necessary details required on Form 970.

   Therefore, if the taxpayer is on the LIFO method, request the original election form for review. This form should state which particular method will be used (Unit vs. Dollar-Value), whether different pools will be used and the specific method for computation of the dollar-value indexes (Double extension, producer price index, etc.).

   For the taxpayer to use the LIFO method, the taxpayer must establish no method other than LIFO has been used in his or her report or statement of income, profit, or loss to shareholders, partners, other proprietors, beneficiaries, or for credit purposes.

   During certain unfavorable economic conditions, the taxpayer may seek termination of the LIFO method using this violation. Review the financial statements for the inventory method utilized and make a determination whether any violation of the financial statement requirement was made intentionally.

   If a certified audit has been performed, obtain a copy of the balance sheet and footnotes to determine what inventory method was used for financial statement presentation.

Long-Term Contracts

Treas. Reg. section 1.451-3(b)(1)(ii) provides that a manufacturing contract is a long-term contract only if such contract involves the manufacture of:

1. Unique items of a type which are not normally included in a taxpayer's finished goods inventory.

   or

2. Items which normally require more than 12 calendar months to complete regardless of the duration of the actual contract.

Long-term contracts are covered by IRC section 460 and a discussion of these items is beyond the scope of this guide. The examiner will need to thoroughly research this issue when discovered during an examination.

INVENTORY INTERVIEW

1. Does the taxpayer use the accrual method of accounting? ___
   If not, explain.

2. Has there been a change in the way the inventories are valued? _______
   If yes, was it done with the Commissioner's approval? _____

3. Does the method of valuing inventory conform to the best accounting practice in the industry and clearly reflect income as required by Treas. Reg. section 1.471-1? _____
   If not, explain.

4. Does the beginning inventory shown on the return under examination agree with the ending inventory shown on the prior year return? _____
   Does it agree with the book income at the end of the prior tax year? _____
   If not, explain.

5. Does the ending inventory shown on the return under examination agree with the general ledger? _____

6. Is a copy of the inventory count sheets available? _____
   If yes, check prices, extensions, etc.

7. Are there any unusual debits/credits to the inventory accounts? _____
   If yes, explain.

8. Are there any unusual debits/credits to the cost of sales? _____
   If yes, explain.

9. Check for gross profit percentage variations.

10. Has a certified audit been performed? _____
    If yes, secure a copy and note any statements regarding inventory.

11. Does the taxpayer reflect all direct and indirect costs in inventory? _____
    If not, explain.

12. Were yearend purchases included in ending inventory? ____

13. Does the taxpayer recognize cash discounts as (a) income or (b) reductions in cost?

14. Does the taxpayer make personal withdrawals of inventory? ______
    If so, how is it handled?

15. Does the taxpayer ship merchandise on consignment? _____
    If so, how is it handled for inventory purposes?

16. Has the taxpayer received any merchandise on consignment? ______
    If title has passed, it should be in inventory.

17. Has any inventory been written down? _____
    Secure list of write downs to see if the taxpayer complied with Treas. Reg. section 1.471-2.

18. Has the taxpayer "sold" inventory to another company in a transaction that could be characterized as a financing arrangement? _____
    See Rev. Rul. 83-59, C.B. 1983-1, 103.

19. Has the taxpayer included IRC section 263A costs in inventory? _____

20. As a manufacturer, has the taxpayer complied with Treas. Reg. section 1.471-11? _____

COST OF SALES AUDIT PLAN

The purpose is to:

1. Identify costs associated with production.

2. Verify amounts.

3. Consider timing and consistency in method of accounting for these costs.

4. Determine whether the appropriate costs are properly matched to sales per IRC section 471 and IRC section 263A.

Procedures:

1. Reconcile the general ledger to the Form 1120 Schedule A (through accountant's grouping worksheet).

   Prepare a workpaper comparing cost of sales detail for at least three consecutive years and note the following:

   a. Changes in dollar amounts from year to year
   b. Direction of dollar amount changes
   c. Types of costs listed. Are accounts consistent from year to year?

      Are there any unusual types of accounts? Are the appropriate types of costs listed? The absence of a typical account category may be an indicator that audit expansion is warranted, that is, no "Other Costs" listed, no UNICAP costs included.

2. Perform ratio analysis:

   Three year comparative)
   - Gross profit percent
   - Inventory turnover rate
   - Number of days supply in inventory
   - O/H absorption rates
   - UNICAP absorption rates
   - Direct materials
   - Direct labor
   - Other costs

- Inventory pattern
- Percent of WIP and finished goods to total inventory.

3. Analyze M)1 adjustments related to inventories to determine if proper. Assess the impact of the adjustment to cost of sale as it relates to income (+/)).

   Prepare a workpaper comparing inventory related book to return adjustment detail for multiple years and note the following:

   a. Type of M)1 adjustments

   b. UNICAP with related IRC section 481(a) adjustment

   c. Inventory Reserves (IRC section 461)

   d. Standard Cost Variances (Treas. Reg. section 1.471)11(d)(3)(ii)(a)).

   Observe patterns and note material changes (direction of an amount change, account change, material amount changes, account relationships).

   Isolate and reconcile IRC section 263A, UNICAP, and the associated IRC section 481(a) adjustment to the amount(s) presented on the tax return.

   Be sure a good understanding is achieved regarding ALL M)1 adjustments. Analyze the rationale underlying a difference in book and tax and the effect that any discrepancy may have on tax (noting permanent versus timing differences).

4. Breakout other costs summary (workpaper provided by tp) by department, if necessary. Determine whether substantive tests are to be performed.

5. Secure and inspect physical inventory count documents for beginning and ending of year. A summary workpaper is okay if the individual count documents are not available.

6. Verify adequacy of internal control procedures over inventories.

7. Flowchart the production process from a functional versus recordkeeping standpoint.

8. Secure and inspect workpapers allocating overhead (other costs) to WIP and finished goods.

9. Identify direct labor personnel.

10. Identify the character of raw material/purchases.

11. Secure and inspect workpapers identifying UNICAP costs, identifying and allocating mixed service costs, and allocating (burdening) these costs to inventories.

12. Ascertain consistency in accounting treatment with respect to inventory valuation (GAAP and UNICAP). Multiple year UNICAP verification (to include IRC section 481(a) computation).

13. If applicable, analyze the standard costing system for valuation of standards utilized and variance treatment.

14. If technical clarification is necessary, interview appropriate person (program manager, production manager).

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TP:
AUDIT ITEM: INVENTORY **DATE:**
FILE NAME: 5101.WPF **INITIAL:**

YEAR:	**W/P REF**	**YEAR:**	**W/P REF**	**YEAR:**	**W/P REF**
P/R:					
P/E:	_______		________		________
ADJ:	=========		==========		=========

SUMMARY OF ADJUSTMENT: **(SEE W/P:)**

These techniques are not intended to be all-inclusive nor are they mandatory steps to be followed. Judgment should be used in selecting the techniques that apply to each taxpayer.

AUDIT PROCEDURES **W/P REF**

1. Inventory Issue Specialist may be of assistance.

2. Compare inventory balances with prior and subsequent years' returns.

3. Check for gross profit percentage variations, investigate material deviations.

4. Determine whether a consistent and acceptable pricing method has been used (Acceptable methods listed in Treas. Reg. sections 1.471-1 through 1.471-8).

5. Check for unauthorized changes in valuing inventory (See file name 5500.WPF for changes in accounting method).

6. Analyze obsolete inventory write downs.

   a. Determine if there have been write-downs for “excess” inventory -- refer to Rev. Rul. 80-60 and ***Thor Power Tool*** (439 U.S. 522)(79-1 U.S.T.C.)

INVENTORY TECHNIQUES (CONTINUED) 5101.WPF **W/P REF**

b. Determine if "obsolete inventory" is retained by taxpayer. If taxpayer retains "obsolete inventory" question obsolescence. Parts and supplies kept by the taxpayer for use on inventory which is no longer in production cannot be written off until its disposition is complete.

7. Determine if IRC section 263A applies. (For specific IRC section 263A techniques see file name 5105.WPF).

8. Determine that inventory costing conforms to Treas. Reg. Sections 1.471-11 (full absorption method) for manufacturing and production activities.

   a. Obtain the list of expense accounts which taxpayer (TP) has allocated to YE Inventory. Determine if indirect expenses which have not been allocated should be.

   b. Where a standard cost system is used, review the factors comprising the standard and analyze the disposition of variances at yearend.

   c. Sample invoices on items in YE inventory to ensure that cost includes invoice price less discounts plus all transportation-in cost plus import duties. (Treas. Reg. section 1.471-3(b)).

9. Trace YE purchases (in-transit and accruals) to a receiving document to see if they were received after the YE physical count. If so, ensure that appropriate adjustments were made to increase YE Inventory.

10. Analyze credit memos on items returned after the YE inventory count and ensure that YE inventory is increased appropriately.

11. Determine compliance with Treas. Reg. sections 1.472-1 thru 6 for LIFO inventories (See file name 5104.WPF on LIFO techniques).

INVENTORY TECHNIQUES (CONTINUED) 5101.WPF **W/P REF**

12. Determine the meaning and significance of any notes or qualifying statements on financial reports.

13. Review AJEs to inventory to ensure that no reserve for anticipated losses has been deducted.

14. For TPs using percentage of Completion:
    verify that materials and supplies on hand at the job sites are included in the computation of the completion percentage.
    Treas. Reg. section 1.451-3(c).

15. For TPs using completed contract method:
    Determine the correctness of work-in-process at yearend. Treas. Reg. section 1.451-3 itemizes the indirect cost that must be allocated to ending work-in-process.

16. For manufacturers using a standard cost system, review the factors comprising the standard and the disposition of variances at yearend.

TP:
AUDIT ITEM: PURCHASES **DATE:**
FILE NAME: 5102.WPF **INITIAL:**

YEAR:	W/P REF	YEAR:	W/P REF	YEAR:	W/P REF
P/R:					
P/E:	________		________		________
ADJ:	=========		==========		=========

SUMMARY OF ADJUSTMENT: **(SEE W/P:)**

These techniques are not intended to be all-inclusive nor are they mandatory steps to be followed. Judgment should be used in selecting the techniques that apply to each taxpayer.

AUDIT PROCEDURES **W/P REF**

1. See Expense Account techniques -- file name 5260.WPF.

2. Reconcile books to return and analyze yearend AJEs to ensure their correctness.

3. Determine the correctness of large and unusual AJEs to purchases throughout the year.

4. Scan purchase account for unusual vendors, vouch these to invoice. (Example: debits to COS with cash or SH listed as the vendor.)

5. On a sample basis, scan the endorsements on the back of the canceled checks. Look for potential personal expense and diverted income.

6. Test check purchases at yearend by tracking purchase to a sales date in the current year or to yearend inventory.

7. Analyze credit memos on items returned after inventory count and ensure that ending inventory is increased appropriately.

TP:
AUDIT ITEM: COS-LABOR **DATE:**
FILE NAME: 5106.WPF **INITIAL:**

YEAR:	**W/P REF**	**YEAR:**	**W/P REF**	**YEAR:**	**W/P REF**
P/R:					
P/E:	________		________		________
ADJ:	=========		==========		=========

SUMMARY OF ADJUSTMENT: **(SEE W/P:)**

These techniques are not intended to be all-inclusive nor are they mandatory steps to be followed. Judgment should be used in selecting the techniques that apply to each taxpayer.

AUDIT PROCEDURES **W/P REF**

1. Determine if the TP is correctly classifying independent contractors for possible employment tax issues by applying the Common Law Factors to the facts of the case.

2. Verify that appropriate information returns are filed (that is, Forms 1099, W-2).

3. On payments of large amounts to questionable payees, pull up RTVUE to verify the amounts were reported.

4. Question the taxpayer about self-constructed assets and internal repair policies. Make sure that the labor expense is properly classified: current expense versus capital expense.

5. Verify that related parties are dealing at arms length and that payments are actually made.

6. Make sure the payments are properly attributable to your tax year, that is, that they don't belong in ending inventory.

TP:
AUDIT ITEM: COS-OTHER EXPENSE **DATE:**
FILE NAME: 5103.WPF **INITIAL:**

YEAR:	W/P REF	YEAR:	W/P REF	YEAR:	W/P REF
P/R:					
P/E:	________		________		________
ADJ:	=========		==========		=========

SUMMARY OF ADJUSTMENT: **(SEE W/P:)**

These techniques are not intended to be all-inclusive nor are they mandatory steps to be followed. Judgment should be used in selecting the techniques that apply to each taxpayer.

AUDIT PROCEDURES **W/P REF**

1. Analyze the TP's list of expense accounts in Cost of Goods Sold. Look for direct and indirect expenses which should be included but are not. (That is, freight-in should be included unless freight-in is included in cost valuation.)

2. IRC section 263A expenses which should be capitalized to yearend inventory may be found here -- see file name 5105.WPF.

3. See General Expense guidelines -- file name 5260.WPF

TP:
AUDIT ITEM: IRC 263A **DATE:**
FILE NAME: 5105.WPF **INITIAL:**

YEAR:	W/P REF	YEAR:	W/P REF	YEAR:	W/P REF
P/R:					
P/E:	________		________		________
ADJ:	=========		==========		=========

SUMMARY OF ADJUSTMENT: **(SEE W/P:)**

These techniques are not intended to be all-inclusive nor are they mandatory steps to be followed. Judgment should be used in selecting the techniques that apply to each taxpayer.

AUDIT PROCEDURES **W/P REF**

1. Determine if the provisions of IRC section 263A apply to TP. In general applies to (a) all manufacturers and (b) all TP's involved in resale with gross receipts of more than $10,000,000.

2. If the TP is a manufacturer and no full absorption nor IRC section 263A indicated on the return, interview TP to determine composition of ending inventory (EI) -- raw materials, WIP, and finished goods.

3. If TP has EI of raw materials only, allocate only purchasing costs, depreciation and/or rent on storage, and utilities on storage. Allocate to EI by applying a ratio to the total allocation amount. The ratio is determined by dividing average inventory by total purchases. Be aware that unless this ratio or the amount to be allocated is relatively high, the adjustment will be minimal.

IRC 263A AUDIT PROCEDURES 5105.WPF **W/P REF**

4. If the TP's EI does not consist of only raw materials and the TP has not used full absorption (called for under Treas. Reg. section 1.471-11), then the EI must first be computed using the IRC section 471 rules. TP can use any reasonable method (EI/CGS x Indirect costs). Next the IRC section 263A amount above the IRC section 471 adjustment must be determined. The Simplified Production method must be used to allocate costs to EI unless the TP can show that a specific allocation is better. This method is as follows:

   TP's total add'l IRC section 263A costs incurred during taxable year / TP's total IRC section 471 costs incurred during the taxable year = Absorption Ratio

   Absorption Ratio x Total IRC section 471 costs in ending inventory that were incurred during the year = Total add'l Costs in EI

5. If the manufacturer is already on full absorption, review the IRC section 263A computation by obtaining the TP's computation with a list of items classified as IRC section 263A expense. Compare the list with the attachment. If any costs are missing, plug these into the TP's formula.

6. Ensure that TP has included a percent of officer's wages for time devoted to production (supervising and purchasing duties). Ensure that TP has included labor cost for employees involved in purchasing and fringe benefits on allocable labor cost.

7. IRC section 263A does not apply to personal property described in IRC section 1221(1) acquired for resale by a reseller whose average annual gross receipts for the 3 previous taxable years do not exceed $10,000,000 (small reseller). Treas. Reg. 1.263A-3(a)(1).

8. Determine if the TP has any IRC section 263A costs -- limited list of items that must be allocated.

IRC 263A AUDIT PROCEDURES 5105.WPF **W/P REF**

9. The regulations provide two simplified resale methods: simplified resale method without historic absorption ratio election and simplified resale method with historic absorption ratio election. See Treas. Reg. sections 1.263A-3(d)(3), (4). Under the simplified resale method without historic absorption ratio election, additional IRC section 263A costs allocable to eligible property on hand at the end of the year are computed by multiplying the "combined absorption ratio" by IRC section 471 costs on hand at yearend. See Treas. Reg. section 1.263A-3(d)(3)(i)(A).

10. Consider IRC section 263A(f) which requires the capitalization of interest costs on debts incurred for the production of "designated property." IRC section 263A(f) applies not only to interest on these debts but also to interest of the TP not directly traced to production expenditures. These provisions affect both self-produced property and property produced for the TP pursuant to a contract. See the proposed final regulations dated August 9, 1991, addressing interest capitalization.

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Chapter 7

IRC SECTION 263A -- UNIFORM CAPITALIZATION

INTRODUCTION

A few words of caution: The general discussion that follows should not be considered a substitute for a thorough reading of IRC section 263A and the related regulations.

IRC SECTION 263A - UNIFORM CAPITALIZATION

Taxpayers subject to IRC section 263A must capitalize all direct costs and certain indirect costs properly allocable to (1) real and tangible personal property produced by the taxpayer and (2) real and personal property described in IRC section 1221(1), which is acquired by the taxpayer for resale.

Despite the fact this specific regulation has been in effect for some time, it has proven to be one of the primary issues involving inventory. Either taxpayers choose to ignore the regulations entirely or they assume any overhead allocation previously made is sufficient to satisfy the requirements.

This section covers the basics of IRC section 263A allocations and provides basic formulas available to either compute an allocation or to test the reasonableness of the taxpayer's method. In addition, IRC section 263A(f) provides rules for the capitalization of interest costs for the production of certain property. In the majority of cases, a manufacturer will fall under IRC section 263A. Certain exceptions involving long term contracts and goods for resale may apply. If this occurs, further research may be required.

Extract

Treas. Reg. section 1.263A-1(a)(3)

"* * * Taxpayers subject to section 263A must capitalize all direct costs and certain indirect costs properly allocable to--

(A) Real property and tangible personal property produced by the taxpayer; and * * *."

The term "produce," per Treas. Reg. section 1.263A-2(a)(1), includes the following: construct, build, install, manufacture, develop, improve, create, raise, or grow.

The costs that must be capitalized in the ending inventory include:

All Direct Costs

This includes direct material costs and direct labor costs. Direct material costs are defined as those which become an integral part of the subject matter and the cost of those materials consumed in the ordinary course of the activity. Direct labor costs include the cost of labor which can be identified or associated with a particular activity. The primary direct labor costs include items such as basic compensation, overtime pay, vacation and holiday pay, sick leave, and employment taxes.

All Indirect Costs Associated with Production

Indirect costs are defined as those costs other than direct costs which directly benefit or are incurred by reason of the performance of a production or resale activity. It is important to note that certain indirect costs are still associated 100 percent with production such as a production supervisor's wages, employment taxes, and fringe benefits related to production. Other indirect costs such as computer costs used to generate both purchases and sales journals are only partly associated with production and must be allocated either using the 90 percent de minimus rule, the simplified methods as provided by the regulations or by another reasonable method allowed the taxpayer.

Examples of indirect costs required to be capitalized

1. Indirect labor costs
2. Officers compensation
3. Pension and other related costs
4. Employee benefit expenses
5. Indirect material costs
6. Purchasing costs
7. Handling costs
8. Storage costs
9. Cost recovery allowances on equipment, including depreciation and amortization
10. Depletion
11. Rent
12. Taxes
13. Insurance
14. Utilities
15. Repairs and maintenance
16. Engineering and design costs
17. Spoilage

18. Tools and equipment
19. Quality control
20. Bidding costs
21. Licensing and franchise costs
22. Interest
23. Capitalizable service costs

Examples of Indirect Costs Not Capitalized

1. Selling and distribution costs
2. Research and experimental expenditures
3. IRC section 179 costs
4. IRC section 165 costs
5. Cost recovery allowances on temporarily idle equipment and facilities
6. Taxes assessed on the basis of income
7. Strike expenses
8. Warranty and product liability costs
9. On-site storage costs
10. Unsuccessful bidding expenses
11. Deductible service costs.

See Exhibit 7-1 at the end of the chapter for a summary of the treatment of costs under IRC section 263A.

Audit Techniques

In an income tax audit, the focus of an IRC section 263A inquiry is whether taxpayer allocated the proper amount of Indirect Production Costs to the ending inventory.

Understand How Ending Inventory is Valued

During the course of an initial interview, you will ask the taxpayer and the representative the question -- Are IRC section 263A costs allocated to the ending inventory? The representative will answer with an authoritative "of course" and point to the tax return to show you they have segregated the IRC section 263A costs in the Schedule A of the Cost of Sales section.

Many times the Schedule A will show the following:

Schedule A Cost of Goods Sold and/or Operations

Inventory at beginning of year	150,000
Purchases	1,200,000
Cost of Labor	750,000
Additional section 263A costs	60,000
Other costs (Statement 5)	65,500
Total - Add lines 1 through 4	2,225,500
Inventory at end of year	175,000
Cost of goods sold and/or operations	2,050,500
	444444444

Statement 5 - Other Costs

Pension Services	10,000
Accounting and Legal	15,000
Automotive Expenses	7,500
Office Supplies & Expenses	20,000
Officer's Expenses	15,000
Telephone	8,000
Various Other Expenses	50,000
Less: Amount of Other Costs included in cost of sales as IRC section 263A Costs	(60,000)
Total Other Deductions	65,500
	44444444

This schedule shows nothing as far as what costs have been allocated to ENDING INVENTORY. The IRC section 263A computation should identify all categories of additional costs that are inventoried via the yearend computation, as well as the calculations to arrive at the amount added to the ending inventory.

The only way to determine whether an allocation has been made is to understand how the taxpayer has costed the ending inventory. The common audit inquiries for this issue are:

1. Are all production/inventory cost categories considered?

2. Are the production/inventory costs categorized correct?

3. Are the percentages used for the mixed service costs reasonable?

Therefore, request the following records:

1. Inventory records for work-in-process and finished goods. Sometimes, the overhead allocation is made right on the summary sheets as a straight percentage computation.

2. Any cost sheets the taxpayer may have which break down the cost allocation into materials, labor, overhead, etc.

3. The accountant's inventory workpapers showing any IRC section 263A computations made.

Computing the IRC section 263A Allocation

After determining the total amount of additional IRC section 263A costs, a manufacturer must allocate these costs between cost of goods sold and its ending inventory. A manufacturer can allocate the additional IRC section 263A costs by using a facts and circumstances method, such as burden rate, or the simplified production method, which is provided by the regulations.

Many manufacturers may divide their general ledger accounts into broad categories such as production, design, selling, or administrative. These classifications should not be the sole means of identifying accounts with production/inventory related costs. For example, the taxpayer may list Rent Expense and Security Expense as administrative, but a significant portion may benefit the production and inventory activities. In other words, you should not rely solely on the taxpayer's general ledger or trial balance groupings.

Treas. Reg. section 1.263A-2(b) provides a simplified method of accounting for production costs. It can be used to determine whether the taxpayer's method is reasonable or it can be used if no allocation was made at all. This method may be used in conjunction with the simplified method for allocating mixed service costs as provided by Treas. Reg. section 1.263A-1(h).

Before the simplified methods can be applied, some preliminary steps must be performed. These steps are:

1. Identify the types of production costs (both direct and indirect) that must be inventoried.

2. Determine the costs previously allocated to ending inventory. These are termed as "Section 471" costs in the regulations. A taxpayer's IRC section 471 costs are the costs, other than interest, capitalized under the taxpayer's method of accounting immediately prior to the effective date of IRC section 263A. Thus, although IRC section 471 applies only to inventories, section 471 costs include any

noninventory costs, other than interest, capitalized or included in acquisition or production costs under the taxpayer's method of accounting immediately prior to the effective date of IRC section 263A. This will usually include at least the direct materials and direct labor and possibly an additional overhead allocation. In many cases it is simpler to readjust the taxpayer's ending inventory figures to include just the direct materials and direct labor amounts. This will be demonstrated later.

3. Then segregate all costs into the following categories:

    a. Direct Production

    b. Indirect Production

    c. Indirect Mixed Service Costs -- These are costs which benefit both production/inventory activities and "excluded" activities. Examples are pension costs that cover employees from all departments of the company, accounting department costs, insurance for the entire plant facility, officers' salaries that were not previously segregated by function.

    d. Nonrelated Production (sales related, administrative related to overall policy making, etc.)

    e. Interest expense and income taxes (Federal/State/Local).

4. Allocate the remaining costs between production and nonproduction activities. This step isolates the total indirect production costs. A portion of this total will be allocated to ending inventory.

5. Determine what portion of total indirect production costs is allocable to ending inventory.

In segregating the costs, determine whether the de minimus rule per Treas. Reg. section 1.263A-1(g)(4)(ii) is applicable. This rule is used in conjunction with the mixed service cost formula and is used to determine whether a cost should be treated solely as a production or a nonproduction cost. The general rule states,

> "* * * if 90 percent or more of a mixed service department's costs are capitalizable service costs, a taxpayer must allocate 100 percent of the department's costs to the production or resale activity benefited."

For example, if it is determined a company's shipping department activities are broken into 90 percent shipping duties and 10 percent receiving duties (incoming purchases), then the entire cost of the shipping costs (wages) should be segregated to the non-production category.

Any other service cost which does not meet the de minimus rule should be placed in the mixed service cost category for future allocation.

If the taxpayer uses accounting methods which are different for book purposes than tax, use the costs generated by the tax method. For example, if the taxpayer uses the straight line method of depreciation for book and MACRS for the tax return, the costs computed under MACRS should be used.

Also, any costs excluded from deduction due to statutory limitations (20 percent entertainment rule, charitable deductions, etc.) will be excluded from the computations.

If adjustments are proposed to expense accounts, then the corrected numbers should be used. Therefore, if an adjustment is made to repairs and maintenance for capitalization of production equipment, the adjusted repairs and maintenance amount should be used along with the adjusted depreciation expense amount which will include the reclassified equipment.

Allocation of Mixed Service Costs

Determine what percentage of the mixed service costs are required IRC section 263A costs. This may be accomplished using the Simplified Service Cost Method per Treas. Reg. section 1.263A-1(h). Once the costs have been segregated, it is a relatively simple allocation formula because it uses the taxpayer's own cost numbers as the basis. The formula is as follows:

$$\text{Total Mixed Service Costs} \times \frac{\text{Total IRC section 263A Production Costs Total for the year *}}{\text{Total of All Costs for the year @}} \quad \text{Portion of mixed service costs allocable to production}$$

Footnotes:

* = Amount **excludes** mixed service costs and interest. Includes the direct production and indirect production costs listed previously.

@= Amount **includes** all costs (production and non-production) except those categorized by the examiner as mixed service costs, interest and Federal/State/Local income taxes.

Computation of Absorption Ratio

You may then proceed with the allocation of the indirect production costs and production related mixed service costs. This can be accomplished through the Simplified Production Method as stated in Treas. Reg. section 1.263A-2(b)(3)(ii). The formula is similar to the mixed service cost method in that it relies upon the taxpayer's own numbers for the allocation method.

The absorption ratio is computed as follows:

$$\frac{\text{Additional IRC section 263A Costs incurred during the taxable year \#}}{\text{IRC section 471 costs incurred during the taxable year}} = \text{absorption ratio}$$

Footnote:

\# = Amount **includes** mixed service costs allocable to production plus allocated indirect production costs.

Computation of the IRC section 263A Amount Allocable to Ending Inventory

Next compute the additional IRC section 263A costs allocable to ending inventory of property produced and other eligible property on hand at the end of the taxable year (Treas. Reg. section 1.263A-2(b)(3)(i)(A)):

Absorption Ratio	x	IRC section 471 costs in ending inventory	=	IRC section 263A costs to add to ending inventory

The regulations define the IRC section 471 Costs as those which were included in inventory under the taxpayer's method of accounting immediately prior to the effective date of the section.

If the taxpayer has only included direct materials and direct labor in their ending inventory computation, this does not present a problem. The denominator simply becomes all the direct material and direct labor costs after adjustments.

However, in many of the cases examined, a percentage such as 10 percent of the direct material and/or direct labor, was added as an "overhead burden" factor. The question then raised is which additional costs should be included in the denominator of the formula.

In this situation, the choice made was to simply eliminate the overhead factor and assume all inventory (IRC section 471) costs were simply direct materials and direct labor. This had the result of computing an absorption ratio which was theoretically too high. The ratio was compensated for by reducing the final adjustment by the overhead percentage factor.

Example 1

263A Costs: $ 300,000

Ending Inventory:

WIP	50,000	(Material/labor)
F/G	100,000	(Material/labor)
Overhead	10,000	(10% of F/G)
Total Ending Inventory	160,000	
	4444444	

Total Section 471 costs for the entire year:

Materials	2,000,000
Labor	1,000,000
Total 471 Costs	3,000,000
	444444444

Simplified Production Method:

263A costs: 300,000 = 10% (absorption ratio)
471 costs: 3,000,000

IRC section 263A Cost added to ending inventory:

WIP/Finished Goods: 150,000 x 10% =	15,000
Less overhead already included:	(10,000)
Final Proposed addition	5,000
	44444444

One word of caution. In using the procedures prescribed by the regulations (simplified service method and production method), the bottom line percentage used to allocate IRC section 263A costs gets filtered and manipulated through a sequence of computations.

It is highly recommended that laptop computers with a spreadsheet program(s) be used to shorten computation time. By being able to recompute an IRC section 263A allocation percentage at a moments notice, you can determine whether it would be necessary to argue that 60 percent rather than 40 percent of an officer's salary should be allocated as an indirect cost.

Application of Simplified Production/Service Cost Methods Example

Following is an example of applying the simplified production cost method:

See Exhibit 7-2 for a copy of the tax return and supporting schedule used in this example.

Example 2

The return and supporting schedules were examined and the examiner has established the following:

1. The amounts reported on this return were determined to be correctly stated.

2. The examiner has applied the de minimis rule under Treas. Reg. section 1.263A-1(g)(4)(ii) to all applicable expenses when inputting the percentages.

3. The taxpayer's final inventory consists of finished goods and work-in-process in the following amounts:

Finished Goods	198,000
Work-in-process	60,679
Total ending inventory	258,679
	4444444

   The examiner has determined the IRC section 471 costs consist of only direct materials, direct wages and certain indirect production costs which have been accepted as correct.

4. The following indirect production costs have been determined to have been included, at the applicable percentages listed on the tax return supporting schedules (Exhibit 7-2), in the ending inventory as IRC section 471 costs:

   a. Insurance - Workers Compensation
   b. Indirect Labor
   c. Payroll Taxes - Production Related
   d. Rent
   e. Repairs/Maintenance
   f. Shop Supplies
   g. Taxes - Personal Property
   h. Utilities - Production Related
   i. Depreciation - Sch A
   j. Equipment Rental.

5. The examiner has determined the simplified production and simplified mixed service cost methods will be used for the IRC section 263A allocation.

   Note that other allocation formulas are available in the regulations if those formulas reasonably allocate the indirect costs.

The first step is to segregate the tax return costs into:

1. Production costs already allocated into inventory ("471 Costs")

2. Direct and indirect production costs not allocated to ending inventory

3. Mixed service costs (MSC)

4. Non-production costs

5. Excluded items such as interest, income taxes, etc.

The breakdown of the costs is as follows:

	Total	Prod.	MSC	Prod.	Other
1. Direct Material	576,183	576,183*			
2. Direct Labor	672,985	672,985*			
3. Freight-in/Shipping	8,537	8,537*			
Direct Production Costs	1,257,705	1,257,705*	0	0	0
4. Insurance - Workers Comp	83,210	83,210*			
5. Indirect Labor (O/S)	113,968	113,968*			
6. Payroll Taxes	157,408	111,760*	45,648		
7. Rent	186,000	186,000*			
8. Repairs/Maintenance	21,951	21,951*			
9. Shop Supplies	15,678	15,678*			
10. Utilities	37,619	37,619*			
11. Depreciation - Sch. A	26,912	26,912*			
12. Equipment Rental	61,391	61,391*			
Indirect Production Costs	704,137	658,489*	45,648	0	0

(continued on next page)

	Total	Prod.	MSC	Prod.	Other
13. Officer Compensation	196,000	98,000+	68,600	29,400	
14. Salaries	81,397		81,397		
15. Bad Debts	12,333			12,333	
16. Taxes (Not incl FIT/SIT)	3,451	2,933+	518		
17. Depreciation	11,534	11,534			
18. Advertising	15,732	15,732			
19. Accounting	8,482	8,482			
20. Auto	24,318	8,268+	8,025	8,025	
21. Bank Service Charges	1,396	1,396			
22. Commissions	145,978	145,978			
23. Delivery	8,996	8,996			
24. Enter (After 20					
25. Insurance	19,718	10,845+	5,915	2,958	
26. Legal & Professional	15,881	15,881			
27. Miscellaneous	1,278	1,278			
28. Office Supplies	20,061	20,061			
29. Telephone	27,856	5,571+	13,928	8,357	
30. Trade Shows	23,313		23,313		
31. Travel	13,602		13,602		
32. Utilities	1,318		1,318		
33. Interest Expense	43,512				43,512
34. State Income Taxes	7,500				7,500
35. Federal Income Taxes	13,992				13,992
G&A Costs	713,009	125,617+	242,941	279,447	65,004
	)))))))))	)))))))))	)))))))	)))))))	)))))))
Total Costs:	2,674,851	2,041,811	288,589	279,447	65,004
	444444444	444444444	4444444	4444444	4444444

Footnotes:

* = Section 471 costs (Previously allocated to inventory) = $1,916,194
\+ = Production related costs not in ending inventory = $ 125,617

The above amounts include all adjustments being proposed by the examiner.

1. For **PRODUCTION RELATED COSTS**, segregate all direct and indirect costs already included in inventory (Section 471 Costs) and those not included in inventory (Allocable 263A costs).

Production Costs allocated into ending inventory:	1,916,194
Production Costs not allocated into ending inventory:	125,617

2. Segregate the remaining costs into those which benefit both production and nonproduction departments **(MIXED SERVICE COSTS)** and those that only benefit the nonproduction departments. Exclude interest and income taxes from the allocations.

Mixed Service Costs: 288,589
NonProduction Costs: 279,447

3. Determine how much of the mixed service costs should be allocated to production. This may be accomplished in several ways. The examiner may isolate the administrative costs and through interviews with the taxpayer, allocate a different percentage based on hours or salaries related to production versus nonproduction. However, a simple method is through the use of the Simplified Service cost method as defined previously.

   Using the above numbers, the **ALLOCATED IRC SECTION 263A MIXED SERVICE COSTS** is computed as follows:

   (Production Related)

   1,257,705 + 658,489 + 125,617
   ))))))))))))))))))))))))))))))) x 288,589 = 253,847
   2,674,851 - 65,004 - 288,589 (Total Mixed Service Costs)
   (Total Expenses less Interest,
   Income Taxes and Mixed Service
   Costs)

   Therefore, 253,847 will be considered production related mixed service costs or IRC section 263A costs.

4. The next step is to apply the Simplified Production Method as defined previously and compute the **ABSORPTION RATIO** using the computed IRC section 263A costs and the total IRC section 471 costs as follows:

   a. IRC section 263A production costs allocation:

Indirect Production Costs requiring allocation:	125,617
Mixed Service Costs requiring allocation:	253,847
	379,464
	4444444

   b. Absorption Ratio:

263A Costs:	379,464
	)))))))) =) 19.803
471 Costs:	1,916,194

5. Compute the **IRC SECTION 263A ALLOCATION TO ENDING INVENTORY**:

Section 471 Ending Inventory:	258,679
Absorption Ratio:	x .19803
Addition to Ending Inventory:	51,226
	444444444

LEADSHEET

SECTION 263A EXERCISE

Based on the previous example, complete the following:

1.	Ending Inventory before 263A adjustment	______________
2.	Section 471 costs	______________
3.	Section 263A costs	______________
4.	Total Production Costs, excluding Mixed Service Costs & Interest	______________
5.	Total Operating Costs, exclusive of Mixed Service Costs, Interest, & Income Costs	______________
6.	Simplified Service Costs	______________
7.	Add'l Costs to be capitalized	______________
8.	Absorption Ratio	______________
9.	Section 263A Adjustment	______________
10.	Adjusted Ending Inventory	______________

IRC SECTION 263A REGULATIONS: POST 1993

The uniform capitalization rules do not apply to inventories valued at market under the lower of cost or market method if the market valuation used by the taxpayer generally equals the property's fair market value. However, IRC section 263A does not apply in determining the market value of any inventory where market is determined with reference to replacement cost or production cost. See IRC section 471-4 and Treas. Reg. section 1.263A-1(a)(3)(iv).

The final regulations made changes to both goods held for inventory and for resale. Because the modifications are too numerous to list, a few of the changes or clarifications relating to manufacturers in general are highlighted below:

1. The uniform capitalization rules do not apply to inventories valued at market under either the market method or the lower of cost or market method if the market valuation used by the taxpayer generally equals the property's fair market value. For this purpose, the term "fair market value" means the price at which the taxpayer sells its inventory to its customers less, if applicable, the direct cost of disposing of the inventory. However, the uniform capitalization rules do apply in determining the market value of any inventory for which market is determined with reference to replacement cost or reproduction cost.

2. IRC section 263A rules will not apply to producers who have total indirect costs of $200,000 or less and use a simplified production method. Indirect costs:

   a. Are defined as all costs (including additional IRC section 263A costs) other than direct material and labor.

   b. Exclude any category of indirect costs that is not required to be capitalized such as distribution and selling costs.

   c. Include indirect costs of related parties under the more than 50 percent common ownership test.

   The de minimis rule treats these producers as having no additional IRC section 263A costs for purposes of the simplified production method.

3. The new regulations added several additional costs which are not required to be capitalized. These include IRC section 179 costs (the election to expense certain depreciable business assets) and warranty and product liability costs.

4. The new regulations now allow the election of a historic absorption ratio rather than the taxpayer having to recompute a ratio year after year. The historic absorption ratio is used to calculate the additional IRC section 263A costs added to ending inventory. The taxpayer must:

a. Have used the simplified production method for 3 or more consecutive years prior to the year of election

b. Have used an actual absorption ration for its 3 most recent consecutive taxable years

c. Not be eligible for the $200,000 indirect cost de minimis rule.

IRC SECTION 263A REGULATIONS: POST 1993 FOR SELF-CONSTRUCTED ASSETS AND INTEREST CAPITALIZATION

The final regulations made changes to self-constructed assets. Some areas of concern are if a taxpayer has property produced for them under contract with a third party, they may be subject to the 263A rules under IRC section 263A(g)(2) as if they had constructed the asset themselves.

In addition, the taxpayer may be subject to interest capitalization rules under IRC section 263A(f). If these areas are encountered, research these sections thoroughly.

EXHIBIT 7-1

UNICAP GUIDELINES

The following listing reviews common costs and the treatment required under UNICAP for costs directly associated with the production activities. Mixed Service Costs benefit the operation as a whole and must be allocated between the costs centers to which they apply.

Description	Production	Non Production	Mixed Service Cost
Direct Labor	X		
Direct Materials	X		
Repairs/Maintenance - Production	X		
Repairs - not production		X	
Utilities	X		
Rent	X		
Indirect Labor	X		
Material & Supplies	X		
Small Tools & Equipment	X		
Quality Control	X		
Excise Tax (Paid Prior to Sale)	X		
Income Taxes		X	
Real Estates Taxes	X		
Payroll Taxes	X		
Depreciation	X		
Amortization	X		
Allocable Administration Costs	X		
Officer's Salary (Production)	X		
Insurance	X		
Pension Plans	X		
Employee Benefits	X		
Bottling & Packaging Labor	X		
Rework labor (scrap, spoilage)	X		
Warehousing	X		
Off-site Storage	X		
Purchasing Dept	X		
Shipping (Purchases)	X		
Shipping (Sales)		X	
Marketing & Promotion			X
Selling Expenses		X	
Strikes		X	
G&A - Directly for Production	X		
Mixed Service Costs Personnel			X
Data Processing		X	
Accounting			X
Security Services			X
Management - Overall Policy	X		
Tax Department	X		
Internal Audit	X		

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Form **1120** — Department of the Treasury, Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 1996 or tax year beginning .... , 1996, ending .... , 19 ...
▶ Instructions are separate. See page 1 for Paperwork Reduction Act Notice.

OMB No. 1545-0123 — **1996**

A Check if a:
1 Consolidated return (attach Form 851) ☐
2 Personal holding co. (attach Sch. PH) ☐
3 Personal service corp. (as defined in Temporary Regs. sec. 1.441-4T—see instructions) ☐

Use IRS label. Otherwise, print or type.

Name: Balsa Furniture Manufacturing Co., Inc.
Number, street, and room or suite no. (If a P.O. box, see page 6 of instructions.): 2351 Oaktree Avenue
City or town, state, and ZIP code: Los Angeles, CA 90000

B Employer identification number: 32 1234567
C Date incorporated: July 1, 1972
D Total assets (see page 6 of instructions): $ 860,531

E Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Change of address

Section	Line	Description	Line	Amount
Income	1a	Gross receipts or sales 2,710,115 b Less returns and allowances ____ c Bal ▶	1c	2,710,115
	2	Cost of goods sold (Schedule A, line 8)	2	1,588,396
	3	Gross profit. Subtract line 2 from line 1c	3	
	4	Dividends (Schedule C, line 19)	4	
	5	Interest	5	15,154
	6	Gross rents	6	
	7	Gross royalties	7	
	8	Capital gain net income (attach Schedule D (Form 1120))	8	
	9	Net gain or (loss) from Form 4797, Part II, line 20 (attach Form 4797)	9	
	10	Other income (see page 7 of instructions—attach schedule)	10	3,212
	11	**Total income.** Add lines 3 through 10 ▶	11	1,140,085
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (Schedule E, line 4)	12	196,000
	13	Salaries and wages (less employment credits)	13	81,397
	14	Repairs and maintenance	14	21,951
	15	Bad debts	15	12,333
	16	Rents	16	186,000
	17	Taxes and licenses	17	168,358
	18	Interest	18	43,512
	19	Charitable contributions (see page 8 of instructions for 10% limitation)	19	
	20	Depreciation (attach Form 4562) — 20: 38,446		
	21	Less depreciation claimed on Schedule A and elsewhere on return — 21a: 26,912	21b	11,534
	22	Depletion	22	
	23	Advertising	23	15,732
	24	Pension, profit-sharing, etc., plans	24	
	25	Employee benefit programs	25	
	26	Other deductions (attach schedule)	26	327,557
	27	**Total deductions.** Add lines 12 through 26 ▶	27	1,064,374
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11	28	75,711
	29	**Less:** a Net operating loss deduction (see page 10 of instructions) — 29a		
		b Special deductions (Schedule C, line 20) — 29b	29c	
Tax and Payments	30	**Taxable income.** Subtract line 29c from line 28	30	75,711
	31	**Total tax** (Schedule J, line 10)	31	13,992
	32	**Payments: a** 1995 overpayment credited to 1996 — 32a		
	b	1996 estimated tax payments — 32b		
	c	Less 1996 refund applied for on Form 4466 — 32c ( ) d Bal ▶ 32d		
	e	Tax deposited with Form 7004 — 32e		
	f	Credit from regulated investment companies (attach Form 2439) — 32f		
	g	Credit for Federal tax on fuels (attach Form 4136). See instructions — 32g	32h	
	33	Estimated tax penalty (see page 11 of instructions). Check if Form 2220 is attached ▶ ☐	33	
	34	**Tax due.** If line 32h is smaller than the total of lines 31 and 33, enter amount owed	34	
	35	**Overpayment.** If line 32h is larger than the total of lines 31 and 33, enter amount overpaid	35	
	36	Enter amount of line 35 you want: **Credited to 1997 estimated tax** ▶ **Refunded** ▶	36	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer | Date | ▶ Title

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's social security number

Firm's name (or yours if self-employed) and address ▶ | EIN ▶ | ZIP code ▶

Cat. No. 11450Q

Form 1120 (1996) Page **2**

Schedule A — Cost of Goods Sold (See page 11 of instructions.)

		Line	Amount
1	Inventory at beginning of year	1	250,592
2	Purchases	2	576,183
3	Cost of labor	3	672,985
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	347,315
6	**Total.** Add lines 1 through 5	6	1,847,075
7	Inventory at end of year	7	258,679
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	1,588,396

9a Check all methods used for valuing closing inventory:

(i) ☒ Cost as described in Regulations section 1.471-3

(ii) ☐ Lower of cost or market as described in Regulations section 1.471-4

(iii) ☐ Other (Specify method used and attach explanation.) ▶

b Check if there was a writedown of subnormal goods as described in Regulations section 1.471-2(c) ▶ ☐

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ ☐

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO **9d**

e If property is produced or acquired for resale, do the rules of section 263A apply to the corporation? ☐ Yes ☒ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☒ No

Schedule C — Dividends and Special Deductions (See page 12 of instructions.)

		(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations that are subject to the 70% deduction (other than debt-financed stock)		70	
2	Dividends from 20%-or-more-owned domestic corporations that are subject to the 80% deduction (other than debt-financed stock)		80	
3	Dividends on debt-financed stock of domestic and foreign corporations (section 246A)		see instructions	
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		42	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs that are subject to the 70% deduction		70	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs that are subject to the 80% deduction		80	
8	Dividends from wholly owned foreign subsidiaries subject to the 100% deduction (section 245(b))		100	
9	**Total.** Add lines 1 through 8. See page 12 of instructions for limitation			
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from certain FSCs that are subject to the 100% deduction (section 245(c)(1))		100	
12	Dividends from affiliated group members subject to the 100% deduction (section 243(a)(3))		100	
13	Other dividends from foreign corporations not included on lines 3, 6, 7, 8, or 11			
14	Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15	Foreign dividend gross-up (section 78)			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3 (section 246(d))			
17	Other dividends			
18	Deduction for dividends paid on certain preferred stock of public utilities			
19	**Total dividends.** Add lines 1 through 17. Enter here and on line 4, page 1 ▶			
20	**Total special deductions.** Add lines 9, 10, 11, 12, and 18. Enter here and on line 29b, page 1 ▶			

Schedule E — Compensation of Officers (See instructions for line 12, page 1.)

Complete Schedule E only if total receipts (line 1a plus lines 4 through 10 on page 1, Form 1120) are $500,000 or more.

	(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of corporation stock owned (d) Common	(e) Preferred	(f) Amount of compensation
1	John Doe	000-00-0000	100%	100 %	%	108,000
	Michael Doe	000-11-1111	100%	%	%	88,000
			%	%	%	
			%	%	%	
			%	%	%	

2	Total compensation of officers	196,000
3	Compensation of officers claimed on Schedule A and elsewhere on return	
4	Subtract line 3 from line 2. Enter the result here and on line 12, page 1	196,000

Form 1120 - Supporting Schedules

Balsa Furniture Manufacturing Co., Inc. EIN: 32-1234567

	Total	Prod.	MSC	Non Prod.
Compensation of officers	196,000	50%	35%	15%
Salaries and wages	81,397	0%	100%	0%
Repairs/Maintenance	21,951	100%	0%	0%
Bad Debts	12,333	0%	0%	0%
Rents	186,000	90%	0%	0%
Interest	43,512	)))	)))	)))
Depreciation	11,534	0%	100%	0%
Advertising	15,732	0%	0%	100%
Taxes:				
Payroll Taxes	157,408	71%	29%	0%
Property Taxes	3,450	85%	15%	0%
State Income Tax	7,500	)))	)))	)))
Total Taxes	168,358			
	4444444			
Cost of Goods Sold - Other Costs				
Depreciation	26,912	100%	0%	0%
Equipment Rental	61,391	100%	0%	0%
Freight-in	8,537	100%	0%	0%
Outside Labor	113,968	100%	0%	0%
Supplies	15,678	100%	0%	0%
Utilities	37,619	100%	0%	0%
Workers Comp Ins	83,210	95%	5%	0%
	347,315			
	4444444			
Other Deductions:				
Accounting	8,482	0%	0%	0%
Auto	24,318	34%	33%	33%
Bank Service Charges	1,396	0%	100%	0%
Commissions	145,978	0%	0%	100%
Delivery	8,996	0%	0%	100%
Enter (After 20% Reduce)	15,361	0%	30%	70%
Insurance	19,718	55%	30%	15%
Legal & Professional	15,881	0%	100%	0%
Miscellaneous	1,278	0%	100%	0%
Office Supplies	20,061	0%	100%	0%
Telephone	27,856	20%	50%	30%
Trade Shows	23,313	0%	0%	100%
Travel	13,602	0%	10%	90%
Utilities	1,318	0%	100%	0%
	327,557			
	44444444			

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Chapter 8

CHANGE IN ACCOUNTING METHOD

INTRODUCTION

During the examination of any manufacturer, ascertain whether the correct method of accounting is being used under IRC section 446 and the regulations thereunder. First, the method of accounting must clearly reflect income. Second, if inventories are a material income producing factor, the taxpayer must account for the inventories and the accrual method of accounting must be used.

Because inventory adjustments are not uncommon in the manufacturing industry, you will find it necessary to become acquainted with procedures for making a change in accounting method. Examples of changes in accounting method for inventory include revaluations due to IRC section 263A, changes from the cost to lower of cost or market method, and changes from a FIFO to LIFO method or vice versa.

Under Rev. Proc. 92-20, 1992-1 C.B. 685, the taxpayer may be allowed to spread the adjustment over several years. For involuntary changes in methods of accounting (changes made by the agent) no spread period is allowed. If the taxpayer has initiated a change in accounting method, with regards to costs subject to IRC section 263A, the taxpayer will receive special treatment under Rev. Proc. 94-49, 1994-2 C.B. 705, if the Form 3115, Application for Change in Accounting Method, is filed with the taxpayer's income tax return in the first taxable year beginning after January 1, 1994.

Technical help in making determinations is available so ask your District MSSP Coordinator for the National Change in Accounting Method Specialist or other appropriate assistance.

WHAT IS A CHANGE IN ACCOUNTING METHOD?

Treas. Reg. section 1.446 defines parameters for a change in accounting method. Treas. Reg. section 1.446-1(e)(2)(ii)(c) states, "A change in an overall plan or system of identifying or valuing items in inventory is a change in accounting method. Also a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in accounting method." In other words, under Treas. Reg. section 1.446-1(e)(2), a change in a method of accounting includes: 1) a change in the overall method of accounting for gross income or deductions, and 2) a change in the treatment of a "**material item**."

The regulation also defines a change in a negative fashion, that is, what is not a change in accounting method (that is, correction of errors, changes of any item of income or deduction which does not involve the proper time for inclusion, etc.).

Based on the regulations, a change in accounting method would not include corrections of errors made during a physical count or while totaling the final inventory summary. If an "error" is being corrected (as opposed to a "method"), make the adjustment to the current year return. An increase in the ending inventory due to a correction of an error entitles the taxpayer to an offsetting increase to the beginning inventory of the following year.

A change in accounting would include adjustments to add freight costs to raw materials inventory, to include IRC section 263A costs in inventory, or to revalue a segment of inventory improperly written down under the Lower of Cost or Market Method.

Examiners may be confused because the adjustment is often viewed as "rolling over" to the next tax period. They conclude any tax increase resulting from the year of audit would be given back in the next year. This judgment may be true with correction of errors although consistent errors throughout the years can still result in overall adjustments in the Government's favor. This judgment may also be true for a change in accounting method depending upon the differences in the inventory balances over the years or the existence of net operating losses. The point is, you should not let this argument dissuade you from investigating and developing an issue. Only by determining the consistency and the magnitude of an inventory issue will you know the true tax effect of the adjustments.

A "**material item**" is any item which involves the proper time for inclusion of the item in income or taking of a deduction.

In determining whether a practice involves the proper time for the inclusion of an item of income or the taking of a deduction, the relevant question is generally whether the practice permanently changes the amount of taxable income over the taxpayer's lifetime.

If the practice does not permanently affect the taxpayer's lifetime taxable income, but does or could change the taxable year in which taxable income is reported, it involves timing and is, therefore, considered a method of accounting. **Rev. Proc. 92-20, Section 2.01, 1992-2 C.B. 685**.

The term "material item" should read in context as "material item of gross income or deductions" and not as meaning "a material item of net income."

Examples of change in accounting method are:

1. Cash/Accrual

2. Expense/Depreciation

3. Inventory basis

4. Inventory pools

5. Settlement/Trade date

6. Capitalize/Expense

7. Material and supplies

8. Rebate expense.

The most common items that trigger a change of accounting method where a duplication or omission of income/and or expense occur are:

1. Inventories

2. Accounts receivable

3. Accounts payable

4. Other items which may create a duplication or omission. For example, deferred income and expenses of cash basis taxpayers and accrued income and expense of accrual basis taxpayers.

When a method of accounting is changed relative to an inventory adjustment, there are three different (but related) adjustments:

1. Restate beginning inventory of the year of change using the correct method of accounting.

2. Adjust the ending inventory of the year of change.

3. Because the restatement of the beginning inventory would give rise to a double deduction benefit to the taxpayer, eliminate the duplication by "IRC section 481(a) amount," which is the amount by which the beginning inventory is increased.

WHEN may the Service require a change in a method of accounting?

If a taxpayer's method of accounting does not clearly reflect income, the Commissioner may change the taxpayer's method of accounting to a method that does clearly reflect its income. **See IRC section 446(b).**

Prior acceptance of an unacceptable method does not preclude the Service from subsequently requiring a change. **See for example, *Knight-Ridder Newspaper, Inc.***, 743 F.2d. 781 (11th Cir., 1984).

Where a taxpayer has two separate businesses, the Service may require a change in the accounting method used in one business without requiring a similar change in the other. ***Parker v. Commissioner***, 37 T.C. 331 (1961).

IRC 481 ADJUSTMENT

IRC section 481(a) applies when a change in method of accounting occurs, and it requires that adjustments be taken into account (in the year of change) to prevent items of income or expense from being duplicated or omitted. The IRC section 481 adjustment is cumulative, that is, it can go back to years barred by the statute of limitations. The adjustment is computed as of the beginning of the year for which the method is changed. The IRC section 481 adjustment represents the cumulative differences between the present and proposed methods of accounting as of the beginning of the year of change. A net IRC section 481 adjustment can be either positive which results in an increase in taxable income, or negative which results in a decrease in taxable income.

Under normal circumstances, a taxpayer makes a voluntary change by filing a Form 3115 requesting permission to change and to possibly spread any increase in taxable income over a number of years to avoid a distortion of income. (See Rev. Proc. 92-20, 1992-1 C.B. 685). In an audit situation, the taxpayer's options may be limited or curtailed altogether, depending upon the type of adjustment and the IRC section 481 adjustment must be segregated from what is termed the "current year" adjustment to allow for potentially different treatment.

For the year if change, IRC section 481(b) imposes a limitation on the tax owed because of the adjustment required by IRC section 481(a), if:

1. The entire amount of adjustments under IRC Section 481(a) is taken into account in the year of change

2. The adjustments increase the taxpayer's income by more than $3,000.

IRC section 481 addresses both the amount of adjustment and the tax effect of that adjustment. It only affects the amount of tax owed (for the year of change) resulting from the adjustments required by IRC section 481(a).

Otherwise, the year of change is not affected and neither is the amount of the adjustments for the year of change.

When a method change issue is raised with a taxpayer under examination, and there is no window available for the taxpayer to use Rev. Proc. 92-20, the method change issue is called an examiner initiated method change.

For purposes of this guide, it is assumed any adjustments resulting from changes in accounting methods are those proposed by the examiner under an audit situation and the taxpayer is not eligible to change an accounting method using Rev. Proc. 92-20 (including subsection 6.06).

Before the proper IRC section 481(a) adjustment can be determined, you must first determine the following:

1. Does the change involve a Category A or a Category B method of accounting?

2. What is the "year of change"?

3. What is the IRC section 481(a) adjustment period?

Category A or Category B Method of Accounting

Different treatment of an IRC section 481(a) adjustment may be accorded the taxpayer even under an audit situation depending upon the category of the change. There are two different categories of a change in an accounting method, these being a Category A or a Category B.

A Category A method of accounting is either:

1. A method of accounting which differs from one the taxpayer is specifically required to use; or,

2. A method of accounting the taxpayer is specifically not permitted to use under the Code, the regulations, or a decision of the Supreme Court of the United States.

Examples of Category A methods:

- Use of the cash receipts and cash disbursements method of accounting.

- Omitting selected portions of goods that should be inventoried.

- A write-down of goods in inventory that does not comply with 1.471-2 or 1.471-4 of the regulations.

- A write-down of "excess inventory" to a net realizable value although such inventory has not been scrapped, sold, or offered for sale at the reduced price.

- Ignoring the uniform capitalization requirements of IRC section 263A.

Category B methods of accounting are all methods other than those determined to be Category A methods of accounting.

There is a technical distinction between A and B methods. From a practical point of view, when examiners propose a change to a method of accounting, they are usually addressing Category A methods of accounting.

Year of Change

Rev. Proc. 92-20, 1992-1 C.B. 685, specifies the year of change if the taxpayer files for a change during one of the window periods. If none of the window periods are applicable (and they often are not), the year of change will be the earliest taxable year under examination.

IRC Section 481(a) Adjustment Period

Rev. Proc. 92-20 specifies the adjustment period if the taxpayer files for a change during one of the window periods. If none of the window periods are applicable (and they often are not) or if under section 6.06, the district director has objected to the change during the examination, the entire IRC section 481(a) amount is reported in full in the year of change.

Rev. Proc. 92-20 provides certain time frames (known as "window periods") within which applications by taxpayers must be made.

90 Day Window Period

This window allows the taxpayer to file Form 3115 within the first 90 days after notification of audit. An approved Form 3115 gives the taxpayer a 3-year spread for the IRC section 481 adjustment. If the IRC section 481 adjustment is negative, there is no spread and the year of change is the tax year for which a Form 3115 would be considered timely filed (as of the first day of the 90-day period) as if the taxpayer was not under examination.

120 Day Window Period

For a period of 120 days following the date that the examination ends, a taxpayer may request a change in accounting method even if another examination of the taxpayer has commenced for different tax years unless:

1. The method has been placed in suspense by the examiner

2. The method is included as an item of adjustment in the basic report

3. During the 120 day period, the agent has given the taxpayer written notification, prior to the filing of Form 3115, that the method is an issue under consideration.

30 Day Window Period

For a 30 day period beginning with the first day of the taxpayer's tax year, the taxpayer may file an allowable Form 3115 if the these two conditions are met:

1. The taxpayer has been under examination for at least 18 consecutive months prior to the first day of the tax year

2. The taxpayer has not received written notification from the examiner prior to filing Form 3115 that the method to be changed is not an issue under consideration.

Rev. Proc. 92-20 provides the guidelines for making these determinations. Not only does it provide procedures for taxpayers who wish to obtain the consent of the Commissioner to voluntarily change a method of accounting, it also discusses the procedures applicable to taxpayers under examination. In general, under certain circumstances taxpayers may obtain the Commissioner's consent even after an examination has begun. Rev. Proc. 92-20, particularly Section 6, should be consulted whenever an issue involving a change in a method of accounting arises during an audit.

How IRC Section 481 Interacts With an Inventory Adjustment

When a change in accounting method is proposed for inventory, be aware of the effects on both the beginning and ending inventories. For example, if IRC section 263A costs have not been properly allocated to inventory, you must remember both the beginning and ending inventories are lacking allocations. Therefore, consistency dictates adjustments include both beginning and ending inventory amounts.

This consistency requirement generates two separate tax adjustments. One is termed the "current year adjustment." The other is considered the IRC section 481(a) adjustment. The distinction must be made because each may be taxed differently depending upon the available options allowed by the Code, regulations, and revenue procedures.

As inventory is a balance sheet account, any proposed adjustments affects the cost of sales computation, and eventually taxable income. To simplify discussions in this guide, any changes in inventory are assumed to directly affect taxable income (T.I.) with no mention being made of the intermediate effect on cost of sales. Keep the following in mind throughout the chapter:

Inventory Adjusted	Adjustment	Effect on COGS	Effect on T.I.
Beginning	Increase	Increase	Decrease
Beginning	Decrease	Decrease	Increase
Ending	Increase	Decrease	Increase
Ending	Decrease	Increase	Decrease

For purposes of illustration, assume you are proposing an IRC section 263A adjustment. After adjusting beginning and ending inventories to include proper IRC section 263A allocations for a particular year, the IRC section 481(a) adjustment is the difference between the beginning inventory as adjusted and the beginning inventory as originally stated. The current year adjustment is the difference between the restated beginning and ending inventories. The current year adjustment can either be positive or negative depending upon the relative sizes of the beginning and ending inventories.

<u>Example of Accounting Method Change for Inventory</u>

When a change in accounting method is proposed for inventory, be aware of the effects on both beginning and ending inventories. For example, if IRC section 263A costs have not been properly allocated to inventory, you must remember both the beginning and ending inventory for the year of change is lacking the proper cost allocation. Therefore, consistency dictates adjustments include both beginning and ending inventory amounts.

A method change issue raised in an RAR should report an IRC section 481(a) adjustment including an explanation of the rational; a current year adjustment under IRC section 446; and an IRC section 481(b) computation.

The following examples demonstrate how an inventory method change issue should be analyzed and reported in the RAR.

Example 1

An adjustment is proposed to a manufacturer who never allocated IRC section 263A costs to ending inventories. The year of examination is the accrual basis calendar year ending December 31, 1994, for a Form 1120 filed. The beginning of the year IRC section 263A cost allocation as corrected was $15,000. The end of the year correct cost allocation is $25,000.

	Per Return	263A Adjust.	As Corrected
Begin. Inventory @ 1/1/94..........	50,000	15,000	65,000
Purchases..........................	100,000		100,000
Labor.............................	100,000		100,000
Cost of Goods Available for Sale...	250,000		265,000
Less: Ending Inventory @ 12/31/94..	50,000	25,000	75,000
Cost of Sales.....................	200,000		190,000
	4444444		4444444

RAR, Form 4549 presentation of adjustments discussed above are shown as follows:

	1994
IRC section 481(a) adjustment	$15,000
Current year adjustment	10,000
Aggregate proposed adjustment	$25,000
	4444444

Summary Analysis:

	1/1/94	12/31/94
Inventory as corrected	$65,000	$75,000
Inventory per return	50,000	50,000
		$25,000
IRC section 481(a) Adj.	$15,000	
(positive)	4444444	
	:................	(15,000)
Current year adjustment		$10,000
		4444444

Rational for IRC section 481(a) Adjustment of $15,000:

Under the taxpayer's "old" accounting practice the $15,000 had been deducted in 1993 as the cost of goods sold in 1994 because the beginning inventory for 1994 is increased by $15,000. Thus, to eliminate a duplication of the $15,000 deduction a positive IRC section 481(a) is made as of January 1, 1994.

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

Requirement for both an IRC section 481(a) and Current Year Adjustment in RAR:

By studying the above Example 1, you may conclude it is easier and shorter to simply adjust the ending inventory by $25,000 and report the amount in the RAR as a current

year adjustment. This presentation in a RAR is NEVER appropriate when a change in method of accounting issue is raised and there is an IRC section 481(a) adjustment amount. The RAR should report an IRC section 481(a) adjustment and current year adjustment otherwise the RAR is not technically correct. It must be clear to the taxpayer and a reviewer that a method change under IRC section 446 has been raised in the RAR and there has been a proper application of IRC sections 481(a) and 481(b).

Under the "corrected tax" section on Form 4549, make a note that the tax was computed under IRC section 481(b) for the year of change. Attach an accompanying Form 886-A to the report showing how the IRC section 481(b) tax was computed. As for any subsequent years examined, make a note that the tax was computed using the tax rate schedule.

IRC Section 481(b)(1) and IRC Section 481(b)(2) Limitations

Once the IRC section 481(a) adjustment has been computed, your first consideration is whether the adjustment can be made all in one year. Rev. Proc. 92-20, 1992-1 C.B. 685, mandates certain IRC section 481(a) adjustments be made entirely in the year of change. If the taxpayer is precluded from spreading the IRC section 481(a) adjustment forward, consider the tax limitation of IRC section 481(b).

IRC section 481(b) provides a limitation in the amount of tax an IRC section 481(a) adjustment can generate. It is designed to provide relief to taxpayers who have graduated into higher tax brackets over the years while maintaining the particular method of accounting. Taxation of the entire IRC section 481(a) adjustment in a single year at a higher tax bracket was considered unfair since the adjustment could have been taxed at lower rates had the proper accounting method been in effect. This limitation is created by allocating the adjustment over prior years and computing the resulting increase in tax. Prior years returns are not opened. The limitation per IRC section 481(b) is different than the methods provided for in Rev. Proc. 92-20, 1992-1 C.B. 685.

Before IRC section 481(b) is applicable, several criteria must be met:

1. The IRC section 481(a) adjustment must increase taxable income for the year of change by more than $3,000

2. The same method previously used by the taxpayer was in effect for the previous years the limitation is considered.

If the above criteria have been met, then take the following steps in computing the limitation in tax:

Compute the Tax Solely Associated with the IRC Section 481 Adjustment

The first step is to compute the increase in tax for the year of change which is attributable solely to the adjustments required under IRC section 481(a) and Treas. Reg. section 1.481-1. This increase is the difference between the tax computed by making the IRC section 481(a) adjustment over the tax computed without making the IRC section 481(a) adjustment.

If there are non-IRC section 481 adjustments being proposed, the tax computed on these adjustments must be calculated prior to taking into consideration any IRC section 481(a) adjustments. Once this is performed, this new taxable income is the starting point in determining the tax on the IRC section 481(a) adjustments.

Compute the Tax Under IRC Section 481(B)(1) -- 3-Year Allocation Spread

In this step, the IRC section 481(a) adjustment is equally allocated to the year of change and the 2 preceding taxable years. The increase in tax attributable to the allocation in each such taxable year is the difference between the tax for such year computed with the allocation and the tax as originally stated. Each year's increase is added together to arrive at the total increase attributable to the IRC section 481(a) adjustment.

Compute the Tax Under IRC Section 481(b)(2) -- Prior Years Allocation

If the taxpayer can establish from his or her books and records what his or her taxable income would have been under the new method of accounting for one or more consecutive taxable years immediately preceding the taxable year of change AND the old method has been consistently applied for those consecutive years, then the IRC section 481(b)(2) limitation must also be considered. The total increase in tax due to the IRC section 481(a) adjustment is the sum of each years tax difference computed as follows:

1. Tax computed under the new method of accounting,

   less

2. Tax as originally stated in the return.

Per the regulations, in using the IRC section 481(b)(2) method, any IRC section 481 adjustment not accounted for by the prior year's recomputations is retained in the year of change.

If the taxpayer meets the above criteria, the limitation on the tax is the smallest of the three computations stated above. IRC section 481(c) and the accompanying regulations provide for certain circumstances such as net operating losses, capital loss carrybacks, or carryforwards.

Example 2

Using the information from Example 1, the examiner is also proposing T & E adjustments of $5,000 and omitted interest income of $3,000 for the 9412 year.

Step 1: Compute tax solely associated with IRC section 481(a) adjustment for the 9412 year.

		Tax
Taxable Income per return:	$60,000	$10,000
Non-IRC section 481(a) Adjustments:		
- T&E	5,000	
- Interest Income	3,000	
- Cost of Sales (Current year Adj)	10,000	
Taxable income before IRC section 481(a) adj:	$78,000	14,770
IRC section 481(a) adjustment:	15,000	
Taxable income with IRC section 481(a) adj:	93,000	19,870
Increase in tax due solely to IRC section 481 adj: (19,870-14,770)		$ 5,100

Note: Tax is computed with current year adjustment.

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

	9212 T.I.	9212 Tax	9312 T.I.	9312 Tax	9412 T.I.	9412 Tax
Amounts as originally filed or as adjusted:	30,000	4,500	55,000	8,750	78,000	14,770
IRC section 481(a) allocation (15,000/3)	5,000		5,000		5,000	
Recomputed T.I. and tax	35,000	5,250	60,000	10,000	83,000	16,470
Increase in tax		750		1,250		1,700

Total increase: 3,700

Step 3: The taxpayer states he can recompute his taxable income under the new method for the years 9112, 9212, and 9312 and does so. Because the business was started in 1991, the beginning inventory starts at zero. The beginning and ending inventories are restated as follows:

	9112	9212	9312	9412
Beg. Inv. as originally stated	0	30,000	25,000	50,000
Ending Inv. as originally stated	30,000	25,000	50,000	50,000
IRC section 263A adjustment				
- Beg. Inv.	0	11,500	9,000	15,000
- Ending Inv.	11,500	9,000	15,000	25,000
IRC section 263A adjustment, as computed	11,500	(2,500)	6,000	10,000
Beg. Inv. as corrected	0	41,500	34,000	65,000
Ending Inv. as corrected	41,500	34,000	65,000	75,000
Net effect on T.I.	11,500	(2,500)	6,000	10,000
T.I. as original stated	25,000	30,000	55,000	78,000
T.I. revised	36,500	27,500	61,000	88,000
Tax revised	5,646	4,125	10,250	18,170
Tax before IRC section 481(a)	3,750	4,500	8,750	14,770
Net Tax Effect	1,896	(375)	1,500	3,400

Total Tax Increase 6,421
444444

Step 4: The change in accounting method will be in the smallest of the three net changes above. The tax adjustment resulting from the IRC section 481 adjustment is, therefore, limited to $3,700.

REVENUE PROCEDURE 94-49

Rev. Proc. 94-49, 1994-2, C.B. 705 provides the exclusive procedure for taxpayers to obtain automatic consent to change certain accounting methods required or permitted by Treas. Reg. section 1.263A-1 through 1.263A-3. The procedure is effective for only the first taxable year beginning on or after January 1, 1994. The provisions of Rev. Proc. 92-20 are not applicable to the extent modified by this procedure.

Scope of Rev. Proc 94-49

The procedure provides guidance for taxpayers:

1. Not under examination at the date of publication.
2. Under examination with no "issue pending" as of June 28, 1994.
3. Under examination where an "issue is pending" as of June 28, 1994 in examination or appeals.

Generally, except for the later situation (issue is pending as of June 28, 1994), a taxpayer can use the revenue procedure and obtain a method change for a taxable year beginning on or after January 1, 1994.

If the taxpayer is under examination and there is an "issue pending" as of June 28, 1994, for a taxable year beginning before January 1, 1994, then Rev. Proc. 94-49 is not available. The change in accounting method should then be made in accordance with Treas. Reg. section 1.446-1(e)(3)(i) and Rev. Proc. 92-20, or any other

applicable Code section, regulations, or administrative provisions pertaining to the change. Generally, under these circumstances, the year of change is the earliest year under examination and the entire IRC section 481(a) adjustment is made in the year of the change.

Procedures to Obtain Automatic Consent

An automatic consent is obtained if the taxpayer:

1. Restates beginning inventory as if they had complied with IRC section 263A in prior years.

2. Takes the IRC section 481(a) adjustment into account ratably over 4 taxable years in computing its taxable income regardless of whether the adjustment is positive or negative. If the IRC section 481(a) adjustment is less than $25,000, the taxpayer may elect to take the adjustment into account in the year of change rather than over 4 years.

3. Files a current Form 3115 in duplicate. The original is attached to a timely filed (including extensions) original federal income tax return for the first taxable year beginning after January 1, 1994. A copy of the Form 3115 must be filed with the National Office.

Other

Rev. Proc. 94-49 does not apply to IRC section 263A interest capitalization.

Also under Rev. Proc. 94-49, taxpayers are not allowed to use the historic ratio to restate beginning inventory if the taxpayer is adopting IRC section 263A for the first time.

REVENUE PROCEDURE 95-25

Rev. Proc. 95-25, I.R.B. 1995-18, 13, provides the exclusive procedure for a taxpayer on a simplified production method of accounting for fewer than 3 taxable years to obtain consent to make a historic absorption ratio election under the transition rules of Treas. Reg. section 1.263A-2(b)(4)(v) or Treas. Reg. section 1.263A-3(d)(4)(v). This procedure is applicable only for a taxpayer's first, second, or third taxable year beginning on or after January 1, 1994. A taxpayer complying with all the applicable provisions of this revenue procedure will be deemed to have obtained the consent of the Commissioner to make a historic absorption ratio election under IRC section 446(e).

REVENUE PROCEDURE 95-33

Rev. Proc. 95-33, I.R.B. 1995-28, 7, provides the exclusive procedure for a "small reseller," a "formerly small reseller," or a "reseller-producer" to obtain consent to change its method of accounting for costs subject to IRC section 263A. A taxpayer complying with all the applicable provisions of this revenue procedure will be deemed to have obtained the consent of the Commissioner to make a historic absorption ratio election under IRC section 446(e).

This revenue procedure applies to a reseller-producer changing from a simplified resale method for both its production and resale activities to a permissible UNICAP method for both activities in the first taxable year that it does not qualify under Treas. Reg. section 1.263A-3(a)(4) to use a simplified resale method for both its production and resale activities.

This revenue procedure does not apply to a taxpayer making a historic absorption ratio election under Treas. Reg. section 1.263A-2(b)(4) or Treas. Reg. section 1.263A-3(d)(4).

Rev. Proc. 94-49 is modified so that it does not apply to any taxpayer filing an application for a change in accounting within the scope of this revenue procedure.

COURT CASES

Examples of court cases involving whether there is a change in method of accounting:

Standard Oil Company (Indiana) v. Commissioner, 77 T.C. 349 (1981).

Gimbel Brothers, Inc., 1976-1 U.S.T.C. 9404 (1976) not followed per Rev. Rul. 90-38.

Korn Industries, Inc., 532 F.2d. 1352 (CT.CL. 1976) not followed per Rev. Rul. 77-134.

Schuster's Express, Inc. v. Commissioner, 66 T.C. 588(1976). (Court ruled in favor of taxpayer who claimed it was a correction of error.)

Knight-Ridder Newspaper, Inc., 743 F.2d. 781 (11th Cir. 1984). (Court ruled in favor of IRS and ruled it was a method change.)

Pacific Enterprises,Inc., 101 T.C. 1 (1993).

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Chapter 9

RESEARCH AND DEVELOPMENT

INTRODUCTION

Many taxpayers involved in developing products for sale or for use internally must spend substantial amounts on research and experimentation (R&E) to remain competitive. Consequently, issues related to research and experimental expenses as both a deduction and credit are encountered with increasing frequency.

Research and experimentation costs and the Credit for Increasing Research Activities are addressed in two sections of the Code. IRC section 174, which allows a deduction for Research and Experimental expenditures and IRC section 41, which allows a nonrefundable credit for Qualified Research Expenses.

IRC SECTION 174: DEFINITION OF RESEARCH AND EXPERIMENTAL EXPENDITURES

Under IRC section 174 taxpayers may use one of two methods of accounting for research or experimental expenditures. Taxpayers may deduct their research or experimental expenditures in the tax year in which they are paid or incurred, or they may elect to amortize such expenditures over a period of not less than 60 months. Research or experimental expenditures which are not deducted currently or deferred and amortized, must be charged to a capital account.

On October 3, 1994, the Service published final amendments to Treas. Reg. section. 1.174-2. These amendments clarify the existing definition of research or experimental expenditures and provide guidance regarding the reasonableness requirement of IRC section 174(e) added to the Internal Revenue Code by the Revenue Reconciliation Act of 1989. Since these amendments merely clarify the existing definition of research or experimental expenditures, return positions consistent with the amendments will be consistent with the existing regulations and will be recognized as such by the IRS.

Treas. Reg. section 1.174-2(a)(1) defines research and experimental expenses.

Extract Treas. Reg. section 1.174-2(a) (Revised as of 4/1/97)

(1) * * * the term *research or experimental expenditures*, as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product. The includes the costs of obtaining a patent, such as attorneys' fees expended in making perfecting a patent application. Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents.

(2) For purposes of this section, the term *product* includes any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license.

(3) The term research or experimental expenditures does not include expenditures for --

(i) The ordinary testing or inspection of materials or products for quality control (quality control testing);

(ii) Efficiency surveys;

(iii) Management studies;

(iv) Consumer surveys;

(v) Advertising or promotions;

(vi) The acquisition of another's patent, model, production or process; or

(vii) Research in connection with literary, historical, or similar projects.

(4) * * * testing or inspection to determine whether particular units of materials or products conform to specified parameters is quality control testing. However, quality control testing does not include testing to determine if the design of the product is appropriate.

* * * * * * *

IRC SECTION 41: CREDIT FOR INCREASING RESEARCH ACTIVITIES

IRC section 41[1] provides a credit against tax, which is intended to serve as an incentive to taxpayers to conduct certain types of product development research activities and certain basic research. The credit is an incremental credit equal to the sum of 20 percent of the excess of the taxpayer's qualified research expenses for the taxable year, over a base amount, and 20 percent of the taxpayer's basic research payments. Under IRC section 41(b) qualified research expenses include in)house expenses for wages paid and supplies used in the conduct of qualified research, and 65 percent of any contract expenses for qualified research.

In auditing the research credit, it is important that you determine that the taxpayer is:

1. Performing qualified research

2. Claiming expenses only for qualified research.

DEFINITION OF "QUALIFIED RESEARCH"

For taxable years beginning after December 31, 1985, the definition of qualified research contained in IRC section 41(d) provides four tests for determining whether product development activities, which includes software development, constitute qualified research. The activity must satisfy all four tests in order to qualify. (The final regulations for IRC section 41, adopted May 17, 1989, do not reflect the definition of the term "qualified research.") The Conference Report to the 1986 Tax Reform Act expands upon the four part test for qualified research contained in IRC section 41(d)(1).

The first test is found in IRC section 41(d)(1)(A), which provides that an activity constitutes qualified research only if the cost of that activity may be deducted under IRC section 174. Thus, the cost of the activity must qualify as a research or experimental expenditure as defined in Treas. Reg. section 1.174-2(a).

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[1] The research credit provisions were enacted by the Economic Recovery Tax Act of 1981 as Section 44F. Section 44F was renumbered as Section 30 by the Deficit Reduction Act of 1984. Section 30 was renumbered as Section 41 by the Tax Reform Act of 1986. Former Sections 44F and 30 contained a broader definition of qualified research. Therefore, much of the following discussion of the Section 41(d) definition of qualified research does not apply for taxable years beginning before January 1, 1986.

The second test is found in IRC section 41(d)(1)(B)(i), which provides that in order to meet the definition of qualified research an activity must be undertaken for the purpose of discovering information "which is technological in nature." The Conference Report to the 1986 Act describes this technological test as follows:

> *** * * [t]he determination of whether the research is undertaken for the purpose of discovering information that is technological in nature depends on whether the process of experimentation utilized in the research fundamentally relies on principles of the physical or biological sciences, engineering, or computer science--in which case the information is deemed technological in nature-or on other principles, such as those of economics--in which case the information is not to be treated as technological in nature.**

Footnote 3 further describes qualified research which relies on the principles of computer sciences.

Extract

H.R. Conference Report No. 841, 99th Congress, 2d Sess. (Vol. II) at 71 (1986) (footnote 3).

> **Research does not rely on the principles of computer science merely because a computer is employed. Research may be treated as undertaken to discover information that is technological in nature, however, if the research is intended to expand or refine existing principles of computer science.**

IRC section 41(d)(1)(B)(ii) provides the third test, which requires that the application of the technological information (discussed above) be "intended to be useful in the development of a new or improved business component of the taxpayer. * * *" Thus, qualified research only includes activities related to the development of new or improved business components and, in general, does not include production activities.

The fourth test, found in IRC section 41(d)(1)(C), requires that substantially all the activities related to a research effort constitute elements of a process of experimentation for the purposes described in IRC section 41(d)(3) in order for the research to be qualified research. The Conference Report to the 1986 Act (H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. (vol. II) at 72 (1986)) provides the following description of this process of experimentation test.

> **The term process of experimentation means a process involving the evaluation of more than one alternative designed to achieve a result where the means of achieving that result is uncertain at the outset. This may involve developing one or more hypotheses, testing and analyzing those hypotheses (through, for example, modeling or simulation), and refining or discarding the hypotheses as part of a sequential design process to develop the overall component. Thus, for example, costs of developing a new or improved business component are not eligible for the credit if the method of reaching the desired objective (the new or improved product characteristics) is readily discernible and applicable as of the**

beginning of the research activities, so that true experimentation in the scientific or laboratory sense would not have to be undertaken to develop, test, and choose among viable alternatives.

IRC section 41(d)(4) excludes certain activities from the definition of qualified research. The activities excluded from the definition by IRC section 41(d)(4) are:

1. Any research conducted after the beginning of commercial production of a business component.

2. Any research related to the adaptation of an existing business component to a particular customer's requirement or need.

3. Any research related to the reproduction of an existing business component from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component.

4. Any:

   a. Efficiency survey

   b. Activity relating to management function or technique

   c. Market research, testing, or development (including advertising or promotions)

   d. Routine data collection

   e. Routine or ordinary testing or inspection for quality control.

5. Except to the extent provided by regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in:

   a. Activities which constitute qualified research

   b. A production process which meets the requirements of IRC section 41(d)(1).

6. Any research conducted outside the United States.

7. Any research in the social sciences, arts, or humanities.

8. Any research to the extent funded by any grant, contract, or otherwise by another person or governmental entity.

DEFINITION OF "QUALIFIED RESEARCH EXPENSES"

IRC section 41(b) defines the term "qualified research expenses" and limits the expenditures eligible for the Credit for Increasing Research Activity (research credit). "Qualified research expenses" means the sum of the following amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer that are:

1. In-house research expenses, and

2. Contract research expenses.

The definition of "in-house research expenses" is defined in section 41(b)(2) and means:

1. Any wages paid or incurred to an employee for qualified services performed by such employee.

2. Any amount paid or incurred for supplies used in the conduct of qualified research.

3. Any amount paid or incurred to another person for the right to use computers in the conduct of qualified research. Treas. Reg. section 1.41-2(b)(4) further states that the computer must be owned and operated by someone other than the taxpayer, located off the taxpayer's premises, and the taxpayer must not be the primary user of the computer.

Therefore, almost all the expenses claimed by a taxpayer should fall into one of three categories, "qualified wages," "qualified supplies," and "qualified contract research."

"QUALIFIED WAGES"

"Qualified wages are wages paid to an employee for performing "qualified services." IRC section 41(b)(2)(B) states that "qualified services" means the services of employees who are:

1. Engaging in qualified research, which means the actual conduct of qualified research.

2. Engaging in the direct supervision of qualified research, which means the immediate supervision (first-line management) of qualified research.

3. Engaging in the direct support of research activities which constitute qualified research, which means services in the direct support of either;

    a. Persons engaging in the actual conduct of qualified research, or

    b. Persons who are directly supervising persons engaging in the actual conduct of qualified research.

Direct support of research activities does not include general administrative services, or other services only indirectly of benefit to the research activities. This is true whether general administrative personnel are part of the research department or in a separate department. Direct support does not include supervision.

"Qualified wages" (within the meaning of IRC section 3401(a) are wages subject to withholding.

If substantially all (defined as at least 80 percent) of the services performed by an employee for the taxpayer during the taxable year are for services meeting the definition of "qualified services," then all of the employee's wages are considered qualified wages. If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense.

QUALIFIED SUPPLIES

IRC section 41(b)(2)(C) defines the term "supplies" as any tangible property other than (i) land or improvements to land, and (ii) property of a character subject to the allowance for depreciation.

Treas. Reg. section 1.41-2(b)(2)(i) states, in general, amounts paid or incurred for utilities such as water, electricity, and natural gas used in the building in which qualified research is performed are treated as expenditures for general and administrative expenses and are not "qualified supplies."

Treas. Reg. section 1.41-2(b)(2)(ii) states that to the extent the taxpayer can establish that the special character of the qualified research required additional extraordinary expenditures for utilities, the additional expenditures shall be treated as amounts paid or incurred for supplies used in the conduct of qualified research.

QUALIFIED CONTRACT RESEARCH

A contract research expense is 65 percent of any amount paid or incurred in carrying

on a trade or business to any person other that an employee of the taxpayer for the performance of qualified research or services which, if performed by employees of the taxpayer, would constitute qualified services.

An expense is paid or incurred for the performance of qualified research only to the extent that it is paid or incurred pursuant to an agreement that is entered into prior to the performance of the qualified research and that the taxpayer:

1. Has the rights to the research results

2. Has the agreement require the taxpayer to bear the expense of the research even if the research is not successful.

COMPUTER SOFTWARE DEVELOPMENT COSTS

Revenue Procedure 69-21

In Rev. Proc. 69)21, 1969-2 C.B. 303, the IRS announced that it would allow taxpayers to treat software development costs in a manner similar to that in which research or experimental expenditures are treated under IRC section 174. Taxpayers may elect to expense such costs immediately. The rationale for this is that the costs of developing software in many respects so closely resemble the kind of research and experimental expenditures that fall within the purview of section 174 of the Internal Revenue Code of 1954 as to warrant accounting treatment similar to that accorded such costs under that section.

Revenue Procedure 69)21 defines computer software to include:

> **All programs or routines used to cause a computer to perform a desired task or set of tasks, and the documentation required to describe and maintain those programs. Computer programs of all classes, for example, operating systems, executive systems, monitors, compilers and translators, assembly routines, and utility programs as well as application programs are included.**

While Rev. Proc. 69-21 allows taxpayers to expense software development costs, it does not provide any authority for taxpayers to include such costs in the computation of the research credit. To include such costs in the computation of the research credit, taxpayers must prove that the activities meet the definition of the term "qualified research" under IRC section 41(d) and that the costs are in)house or contract research expenses within the meaning of IRC section 41(b).

Costs to Develop Internal-Use Software

IRC section 41(d)(4) lists certain activities that are not "qualified research" even

though they may satisfy the tests in IRC section 41(d)(1). IRC section 41(d)(4)(E), provides a broad general rule that a taxpayer's software development activities are not qualified research if the software is developed primarily for the taxpayer's own use. However, there are two statutory exceptions and one legislative history exception to the exclusion of internal use software from the credit. If the taxpayer's software development activities fall within one of these exceptions, and otherwise satisfy the requirements of IRC section 41(d), then those activities will constitute qualified research.

The first statutory exception to the exclusion of internal use software from the credit is for software that is used in otherwise qualified research. IRC section 41(d)(4)(E)(I) provides that if the taxpayer is developing software that is to be used as part of its qualified research activities, then the development activities are not excluded from the definition of qualified research by IRC section 41(d)(4)(E). The second statutory exception to the exclusion of internal use software from the credit is for software used in a production process the development of which constitutes qualified research. IRC section 41(d)(4)(E)(ii) states that where a taxpayer is engaging in qualified research in order to develop a new production process, the activities of the taxpayer in developing software related to that production process are not excluded from the definition of qualified research by IRC section 41(d)(4)(E).

The Conference Report to the 1986 Act (H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. (vol. II) at 73-74 (1986)) describes the third exclusion of internal use software from the credit. In that report Congress states:

> The conferees intend that [the] regulations will make the costs of new or improved internal-use software eligible for the credit only if the taxpayer can establish, in addition to satisfying the general requirements for credit eligibility, that
>
> (1) the software is innovative (as where the software results in a reduction in cost, or improvement in speed, that is substantial and economically significant);
>
> (2) the software development involves significant economic risks (as where the taxpayer commits substantial resources to the development and also there is substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period);
>
> (3) the software is not commercially available for use by the taxpayer (as where the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the first two requirement just stated).
>
> The conferees intend that these regulations are to apply as of the effective date of the new specific rule relating to internal-use software; that is, internal-use computer software costs that qualify under the three-part test set forth in this paragraph are eligible for the research credit even if incurred prior to issuance of such final regulations.

The regulations described in the Conference Report had not been published at the time this guide was prepared.

SUMMARY OF COMPUTER SOFTWARE DEVELOPMENT COSTS

Treat the examination of internal use software using a "two prong" approach. You must first review the expenses to determine that they are qualified research expenses. Then review the software development to determine if it is a qualified research activity.

The burden of proof is on the taxpayer to establish that the expenses are qualified research expenses and that the software development activity constitutes a qualified research activity. Have the taxpayer demonstrate that the internal use software meets the requirements outlined in IRC section 41.

In examining the expenses, the taxpayer must prove that the employees claimed for the credit were performing qualified research activities. Contemporaneous records should be produced by the taxpayer to support the claim. If surveys are used, the official completing the survey should be interviewed.

In examining the activity, the taxpayer must show that the internal use software development activity meets all of the general requirements of IRC section 41(d). If those requirements are satisfied, the taxpayer must also meet one of the two statutory requirements in IRC section 41(d)(4)(E) or the exception found in the legislative history.

Consider giving the taxpayer an IDR requesting the taxpayer to verify that the software under examination represents qualified software and meets all the tests under IRC section 41(d) and meets the exceptions under IRC section 41(d)(4)(E).

SPECIFIC ISSUES RELATING TO THE RESEARCH CREDIT

Wages Paid to Technical Writers Re: User Manuals

Issue

Whether the wages paid to technical writers, editors, illustrators, and others who assist in the preparation of user manuals (hereinafter referred to as writers)constitute a "qualified research expense" for purposes of computing the research credit under IRC section 41.

Conclusion

Wages paid to writers who assist in the preparation of user manuals do not constitute a "qualified research expense" for purposes of computing the research credit under IRC section 41.

Employee and Employer Contributions to a Deferred Compensation Plan as Defined in Section 1.401(k) of the Income Tax Regulations

Issue

Do employer and employee contributions, as defined in section 1.401(k)-1(a)(4)(ii) of the Income Tax Regulations, to a trust qualifying under section 401(a) of the Internal Revenue Code made in accordance with section 401(k) constitute "wages" for purposes of section 41(b)(2)(D) of the Internal Revenue Code?

Conclusion

Such payments do not constitute "wages" for purposes of IRC section 41(b)(2)(D). The term "wages" has the same meaning as provided in IRC section 3401(a) for purposes of employee wage withholding. Thus, compensation which is not subject to withholding, such as contributions to certain deferred compensation plans, do not enter into the credit computation even though the contributions maybe by or on behalf of an individual performing qualified services.

Wages Paid to Managers Above the Level of First-Line Supervisors

Issue

Do wages paid to managers who are above the level of first-line supervisors qualify as qualified research expenses for purposes of computing the credit for increasing research activities under section 41 of the Internal Revenue Code?

Conclusion

Only those wages paid to managers performing first-line supervision of qualified research may be included in the computation of the research credit.

Base Period Recomputation

Issue

In computing the credit for increasing research activity under section 41 of the Internal Revenue Code, can the taxpayer recompute its base period research expenses to

eliminate similar items that were disallowed by the Service in the determination year? (The statute of limitations has run on the base period years.)

Conclusion

For tax years prior to 1990 and closed by the statute of limitations, the taxpayer may not adjust its base period research expenses by amounts that are similar in nature to the expenses disallowed by the Service in its determination of qualified research expenses for tax years under examination. The Service can rely on "the duty of consistency" doctrine which prevents a taxpayer who has received a tax benefit in a year barred by the statute of limitations from claiming a tax benefit in a later year.

For tax years after 1989, the taxpayer may adjust its base period research expenses in its determination of qualified research expenses. Qualified research expenses taken into account in computing a taxpayer's fixed-base percentage are to be determined on a basis which is consistent with the determination of qualified research expenses for the current year.

Beta Testing -- Testing Conducted by Customers

Issue

Does the testing performed by a customer of the taxpayer, also known as beta testing, constitute qualified research for the purposes of computing the credit for qualified research activities under section 41 of the Internal Revenue Code?

Conclusion

This is a factual issue. Review the effort performed by the beta tester to determine if this testing is considered to be qualified research. If the testing is performed after commercial production has begun or if the testing is to determine marketing preferences, then it is not considered qualified research.

Costs Attributable to Reviewing a Competitors Product

Issue

Do the costs of activities related to the examination of a competitor's product, otherwise called "reverse engineering," constitute research or experimental expenditures within the meaning of section 174 of the Internal Revenue Code, thus enabling such costs to be considered qualified research expenses as defined in section 41(d) of the Code?

Conclusion

All expenditures related to the study of a competitors product are not considered research or experimental expenditures and thus are not considered qualified research expenses.

Costs to Develop Internal Use Software

Issue

Do costs associated with the development of software to be used internally by the taxpayer constitute qualified research expenditures within the meaning of section 41 of the Internal Revenue Code?

Conclusion

This is a factual issue. Generally speaking, the term "qualified research" does not include research with respect to computer software which is developed by the taxpayer primarily for internal-use per IRC section 41(d)(4)(E). However, if the taxpayer shows that the internal-use software development activity meets the four general requirements of IRC section 41(d) and is able to establish that it is: (1) innovative; (2) involves significant economic risks; and (3) is not commercially available it would qualify for the research credit.

Software Expenditures Capitalized for Book Purposes Per FAS 86

Issue

Should software development expenses capitalized for financial accounting purposes, as required by Financial Accounting Statement No. 86 (FAS 86), be considered an expense which qualifies for the Credit for Increasing Research Activity?

Conclusion

Costs capitalized by a taxpayer for book purposes in accordance with FAS 86 are costs incurred after the technological feasibility of the software has been established. This means that all planning, designing, coding, and testing activities that are necessary to establish that the product can be produced to meet its design specifications have been achieved. The completion of a working model has been established which means that the product performs all the major functions planned and may be ready for beta testing and production.

The provisions of FAS 86 should not be specifically cited as a basis for denying the benefits of the Research Credit. Instead, rely upon the provisions of the Federal

Income Tax statutes as a basis for denial. Therefore, review the specific capitalized expenditures per the schedule M-1 adjustment and base the decision on this review.

Small Tools and Purchased Software

Issue

Are the cost of small tools, purchased software and other capital assets which the taxpayer expensed pursuant to Corporate Expensing Policy qualified research expenses under IRC section 41(b)(2)(A)(ii)?

Conclusion

Qualified supplies are defined as tangible property used or consumed in the research effort that are not of a capital nature. Small tools, purchased software and other capital assets that are considered property that is subject to the allowance for depreciation or amortization do not meet the definition of qualified supplies under IRC section 41 (b)(2)(C) and, therefore, are not considered to be qualified research expenses.

Costs of Developing Generic Drugs

Issue

Whether the costs incurred in the development of generic drugs constitute "qualified research expenses" for purposes of computing the research credit under IRC section 41.

Conclusion

The process of developing a generic drug is the duplication of another taxpayer's business component, an activity specifically excluded from the definition of qualified research by IRC section 41(d)(4)(C). Accordingly, the costs incurred to develop generic drugs do not constitute qualified research expenses for purposes of computing the research credit under IRC section 41.

SUMMARY OF COMPUTATION OF THE RESEARCH CREDIT

The issues listed above have been identified as significant issues dealing with the research tax credit. Issue papers have been developed and are available to examiners upon request. They can be obtained through the National Issue Specialist for Research Credit or through the local ISP District Coordinator.

Case Example: Definition of Qualified Research Expenses With Respect to Wages, Supplies and Contract Research Expenditures

The corporation (hereinafter referred to as "A") is engaged in the development, manufacture and sale of microcomputer mother boards and related computer components. Proprietor chipsets are manufactured and purchased from another company based on "A"'s designs.

The markets for the company's products are intensely competitive. These markets are characterized by rapidly changing technology, resulting in short product life cycles and frequent price declines. "A"'s gross profit has increased as a percentage of net sales from 15.0 percent in fiscal 1988 to 19.9 percent in fiscal 1989, 21.2 percent in fiscal 1990 and 24.7 percent in the fiscal 1991.

"A" believes that technical leadership is essential to its success and is committed to significant expenditures for research and development. As a result, the company's R&D expenses have grown significantly through the years.

A comparative analysis of Gross Sales, R&D Expenses, and R&D Credit claimed are as follows:

Year	Gross Sales	R&D Expenses	R&D Credit Claimed
8812	$26,000,000	$1,500,000	$100,000
8912	$35,000,000	$1,800,000	$175,000
9012	$81,000,000	$5,500,000	$300,000
9112	$100,000,000	$8,000,000	$500,000

In analyzing the taxpayer's books and records, the examiner discovered:

1. Wages paid to a manager above the level of first)line supervisors.

   A highly compensated officer in the research and development division was performing both qualified research work and an activity unrelated to research.

   Per IRC sections 41(b)(1) and 41(b)(2)(B), qualified research expenses include wages paid for the direct supervision or direct support of research activities. The taxpayer claimed that the officer's duties consisted solely of direct supervision of employees engaged in qualified research. The revenue agent closely examined purchase orders in cost of goods sold. The officer was the purchasing agent listed on the purchase order.

   Per Treas. Reg. section 1.41)2(d), an allocation between qualified and unqualified activities is made for wages includible in the credit if less than 80 percent of the employee's services are qualified. The examiner was able to verify that less than 80 percent of the officer's services were allocable to qualified research. The examiner reduced the qualified research expenses for wages paid to the officer allocable to duties performed as purchasing agent.

2. Contract Research Expenditures misclassified as supplies.

   The taxpayer had included a significant amount of the outside contractor's expense (65 percent allowable) as supplies (100 percent allowable).

Per IRC sections 41(b)(1) and 41(b)(2)(C), qualified research expenses includes supplies purchased for use in qualified research. The examiner closely examined invoices for supplies with:

a. Names more closely associated with contractors than vendors,

b. Significant dollar amounts. A portion of these items were payments for contract research expenditures rather than supplies. The examiner reduced qualified research expenses by 35 percent of the contract research expenditures misclassified as supplies.

c. Nonqualified Research and Experimental Expenditures included as Contract Research Expenditures.

   Consulting services were for marketing research.

   The examiner closely examined the "summary of services rendered" attached to the invoice.

   Per Treas. Reg. section 1.174)2, advertising is a statutory exception to the general definition of research and experimental expenditures. The examiner reduced the credit by the contract research expenditures performed for marketing research.

COMPUTATION OF THE RESEARCH TAX CREDIT

Base Amount Computation

Generally for taxable years beginning after 1989, a 20 percent credit for R&E expenditures is permitted to the extent qualified research expenditures for the current year exceed the taxpayer's "base amount" for that year.

The term "base amount" means the amount derived from multiplying (a) the fixed)base percentage by (b) the average annual "gross receipts" of the taxpayer for the 4 tax years before the credit year. But in no event may the base amount be less than 50 percent of the qualified research expenses for the credit year.

The "fixed)base percentage" for a taxpayer who incurred qualified R&E expenses and had gross receipts during each of at least 3 years from 1983 to 1989 is the ratio that its total qualified R&E expenses for any 5 years selected by the taxpayer during the 1983-1988 period bears to its total gross receipts for the 5 years selected.

Nevertheless, this percentage cannot exceed 16 percent. It should be noted that the period for determining the fixed)base percentage is not the same as the base period for determining the "average annual gross receipts."

For a "startup company," the Code had assigned a fixed)base percentage of 3 percent in making the above computation. A start)up company is defined as a taxpayer who

did not have both gross receipts and qualified research expenses during each of at least 3 tax years beginning after 1983 and before 1989. Please note that the 1993 Act changed the computation for start)up companies.

For taxable years beginning before 1990, the above rules do not apply. Instead, for such years the research credit should be computed on the excess of qualified research expenses for that year over "base period research expenses." "Base period research expenses," equals the average qualified research expense paid or incurred for each year in the base period. The base period should be the 3 taxable years immediately before the "determination year."

For tax years after 1989, qualified research expenses taken into account in computing a taxpayer's fixed-base percentage are to be determined on a basis which is consistent with the determination of qualified research expenses for the current year. Thus, if a taxpayer includes (or excludes) certain expenditures in determining its qualified research expenses for the current year, it must provide the same treatment for all such expenditures incurred during any year taken into account in computing the taxpayer's fixed-base percentage, regardless of whether the period for filing a claim for credit or refund has expired for any year taken into account in computing the fixed-base percentage.

Examples of How to Calculate the Credit

Example 1: R&E Credit for Taxable Years Beginning After December 31, 1989

The R&E credit for years after 1989 requires a four step computation. They are:

1. Calculation of the fixed base percentage.
2. Calculation of the base amount.
3. Calculation of current expenses.
4. Calculation of current R&E credit amount.

a. Computation of the Fixed Base Percentage

Year	Qualified Research Expenses	Gross Receipts
1984	$ 25,000	$ 150,000
1985	45,000	300,000
1986	30,000	400,000
1987	35,000	450,000
1988	50,000	500,000
Total	185,000	1,650,000

$$\frac{\$\ 185{,}000}{\$\ 1{,}650{,}000} = 11.21\% = \text{Fixed Base Percentage}$$

b. Calculation of the Base Amount

Year	Gross Receipts
1986	$ 400,000
1987	350,000
1988	450,000
1989	500,000
Total	$ 1,700,000

Average Gross Receipts $ 1,700,000 / 4 =	$ 425,000
Fixed Base Percentage	x 11.21%
Base Amount	$ 47,643

c. Current Qualified Research Expenses

The current years qualified research expenses has been calculated as $73,000. This consists of qualified wages, qualified supplies and 65 percent of the qualified contract research expenses for 1990.

d. Calculation of the Current Year R&E Credit

Current Year Qualified Research Expenses	$73,000
Less: Base Amount	47,643
Total Incremental R&E Expenses	(a) 25,357
50% of current Year Qualified Research Expense	(b) 36,500
Lessor of (a) or (b)	25,357
R&E Credit Percent	x 20%
R&E Credit	$ 5,071

Example 2: R&E Credit for Taxable Years Ending Before January 1, 1990

The R&E Credit for years ending before January 1, 1990, is based on an increase in qualified research expenses over the base period which is the average qualified research expenses over the prior 3 years.

Computation of the Credit for the Year 1989

Years	Qualified Research Expenses
1986	$ 30,000
1987	35,000
1988	50,000
1989	55,000

a. Compute the Base Period
   - Total average Qualified Research Expenses for prior 3 years, (1986-1988) 38,333

b. Qualified Eligible Expenses

- Qualified Research Expenses - 1989	55,000
minus Base Period	- 38,333
- Qualified Eligible Expenses	(a) 16,667
- 50 % of Qualified Research 1989	(b) 27,500
Lessor of (a) or (b)	16,667

c. Calculation of the Credit

- Multiply by 20	x 20%
R&E Credit for 1989	3,333

IRC Section 280(C)(c)(3): Reduction of Credit Verses Expense

A research expenditure may be eligible for both the IRC section 174 deduction and IRC section 41 credit. The IRC section 174 deduction is reduced by 100 percent (for taxable years beginning after December 31, 1989) and 50 percent (for taxable years beginning after December 31, 1988, and before January 1, 1990) of the R&D credit taken.

However, IRC section 280(C)(c)(3) permits the taxpayer to elect a reduced credit instead of reducing the IRC section 174 deduction. For taxable years beginning after 1989, the election limits the taxpayer to a credit in the amount of:

1. The research credit without any reduction, less

2. The product of that credit times the maximum corporate tax rate (currently 34 percent)

For taxable years beginning after December 31, 1988, and before January 1, 1990, the election limits the taxpayer to a credit in the amount of:

1. The research credit without any reduction, less

2. One)half of the product of that credit times the maximum corporate tax rate (currently 34 percent).

Alternative Minimum Tax

Although Congress enacted IRC section 174 to stimulate research, it has also chosen to limit its benefit to taxpayers with too many tax preference items. Some start)up companies that have a net profit immediately, may find their R&D credit limited by the AMT. A solution to the double taxation and limited credit has been to elect S-Corporation status.

The R&D credit (earned by the C-Corporation before converting to an S-Corporation) may not be carried over to the S-Corporation. However, if built)in gains at the time of

the S-Corporation election are recognized in the next 10 years of the S-Corporation, it appears that the C-Corporation's R&D credit may be applied to the additional tax. R&D credit, like the general business credit, may be carried back to the 3 preceding years and carried forward to each of the 15 years after the year of the credit.

RESEARCH AND DEVELOPMENT TAX SHELTERS

Per IRM, "Examination Tax Shelters Handbook" Chapter 900 "Research and Development Tax Shelters," R&D shelters are usually in the form of partnerships set up for the primary purpose of providing the capital necessary to accomplish a specific research project. Typically, an inventor without the capital to finance his or her research activities will take on the role of general partner. The general partner sells limited interests to outside investors. The limited partners furnish recourse notes in addition to the initial cash contributions. Another organization then contracts with the partnership to develop the idea into a marketable product.

The IRM indicates that R&D partnerships may not qualify for IRC section 174 or IRC section 41 for two reasons:

1. The credit is available to only those taxpayers "carrying on a trade or business" as opposed to the standard of IRC section 174 of "in connection with a trade or business." In ***Scoggins v. Commissioner***, T.C. Memo 1991)263; CCH Dec. 47,400(M), certain relevant factors are enumerated: terms of the parties contractual agreements, lack of business activities of the partnership, and the lack of capacity and incentive of the partnership to use the product in its own trade or business.

2. The expense or credit is not intended "for research expenditures when the investor plans to transfer the research results in return for license or royalty payments." The "exclusiveness" of the license is a critical factor here.

AUDIT TECHNIQUES

The National Issue Specialist for the Research Credit has developed two audit guides to assist field examiners in auditing the research credit. One audit guide deals with auditing the research credit in general, the other audit guide should be used when examining a taxpayer who is claiming the research credit for internal-use software. These audit guides are continually being updated and it is best to contact your ISP District Coordinator or the National Issue Specialist for the Research Credit for a copy of the latest audit guide.

Issue papers describing specific issues related to the research credit as mentioned earlier in this chapter have been written and are also available upon request.

MANUFACTURING GLOSSARY

- A -

Absorption costing -- Method of product costing where fixed manufacturing overhead is included in the inventoriable costs.[1]

Accountability center -- Part of an organization that is accountable for a specific set of activities.[2]

Actual costing -- Allocates costs to products using actual direct materials, actual direct labor, and actual factory overhead.[3]

Ad slick -- Manufacturer advertisements printed up with their product on it. These are very complete printings. All the retailer has to do is add their product number and price. This ad is printed in a periodical which is the only cost to the retailer.

Advance -- Partial payment made by the manufacturer to a contractor before the contracted goods are completed. The advance is a short term, non-interest bearing loan from the manufacturer to the contractor.

Advertising allowance -- An allowance given the retailer for cooperative advertising. It is usually allowed only to larger retailers with which the manufacturer does a substantial volume of business. The retailer arranges media advertising, catalog, or direct mail promotions featuring the manufacturer's products. The manufacturer's share of the advertising is deducted from amounts otherwise owed to the manufacturer by the retailer.

Applied overhead -- Factory overhead allocated to services or products, usually based on a predetermined rate.[4]

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1 Charles T. Horngren, Cost Accounting a Managerial Emphasis, 5th ed. (New Jersey: Prentice-Hall, Inc., 1982), p. 964

2 Ibid., pp. 964, 975.

3 Ibid., p. 965.

4 Ibid.

- B -

Backward scheduling[5] **--** Starting with a given date and working backward to determine the required start date.

-C-

Capacity -- Rate of work flow in standard hours through the work center; generally fixed.

Cash discounts -- Discounts given by the manufacturer for prompt payment by customers.

Change order -- An addition or deduction to a contract.

Chargeback -- Underpayment of an invoice due to incorrect billing.

C.I.F. -- Cost, insurance, and freight. A pricing term indicating that the cost of the goods, insurance, and freight are included in the quoted price.

Container -- Used to describe a shipment of goods imported from overseas. Each container will have its own letter or credit number.

Contractor -- An entity that performs a designated operation in the manufacturing process, under contract with the manufacturer. A contractor does not have legal title to the goods. The contractor is paid a negotiated amount, maintains its own workforce, provides its own machinery and equipment, and secures its own facility.

Control capacity -- Control over the labor and machine time used for jobs and work activities by planning and monitoring the time requirements of key work centers.[6]

Control flow -- Control of continuous operations by setting common production rates for all items, feeding work into the system at a specified rate and monitoring the rate.[7]

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[5] American Production and Inventory Control Society (APICS) Dictionary, 3d ed., 1970 (modified and/or condensed.)

[6] Ibid.

[7] Ibid.

Control order -- Control of intermittent operations by monitoring the progress of each individual order through successive operations in its production cycle.[8]

Control priority -- Control over the status of jobs and work activities by specifying the order in which materials and jobs are assigned to work centers.[9]

Conversion cost -- Direct labor plus factory overhead.[10]

Cooperative advertising -- The manufacturer pays up to a specific dollar amount or percentage of net purchases for advertising done by the retailer which is related to the company's product.

Cost center -- Smallest segment of activity for which costs are accumulated.[11]

Cost sheet -- This document lists the quantity and costs of raw materials, freight, labor, allocated overhead, and incidental materials required to produce a product. Used on job order costing to accumulate product costs. Also called job cost sheets, spec sheets or calc sheets.

Custom manufacturer -- Companies which produce goods to a customer's specifications.

- D -

Defective allowance -- Allowance deducted by a retailer to account for anticipated damages. Since the product manufactured is of such small dollar value, the cost to return it from the retailer to the manufacturer would be more than the product itself. Therefore, the retailer will specify an allowance based on the defective pieces found. This percentage will come off the top of the manufacturer's invoice, that is, for a $100,000 invoice with a defective allowance of 3 percent, the retailer will remit $97,000.

Direct costing -- See variable costing.[12]

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[8] Ibid.

[9] Ibid.

[10] Charles T. Horngren, Cost Accounting a Managerial Emphasis, 5th ed.. (New Jersey: Prentice-Hall, Inc., 1982), p. 967.

[11] Ibid.

[12] Ibid., p. 968.

Direct labor costs -- Labor costs which can be identified or associated with particular units or groups of units of a specific product. Direct labor costs would include basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payroll taxes, and payments to a supplemental unemployment benefit plain paid or incurred on the behalf of employees engaged in direct labor.

Direct material costs -- Materials which become an integral part of the specific product and those materials which are consumed in the ordinary course of manufacturing and can be identified or associated with particular units or groups of units of that product.

Direct material inventory -- Material on hand awaiting entry into the production process.[13]

Direct production costs -- Those costs which become an integral part of the product and costs which can be identified or associated with particular units or groups of units of a specific product.

Dispatching -- Selecting and sequencing jobs to be run at individual work centers and actually authorizing or assigning the work to be done. The dispatch list is the primary means of priority control.[14]

-E-

Expediting -- Finding discrepancies between planned and actual work output and correcting them by attempting to speed up the processing in less than the normal lead time.[15]

-F-

Factor -- A business entity that lends money on accounts receivable or buys and collects accounts receivable.

A person who acts or transacts business for another.

Factorage -- The action or business of a factor or the allowance or commission paid a factor.

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[13] Ibid.

[14] American Production and Inventory Control Society (APICS) Dictionary, 3d ed., 1970 (modified and/or condensed)

[15] Ibid..

Factoring -- The business of purchasing and collecting accounts receivable or of advancing cash on the basis of accounts receivable.

F.A.S. -- Free alongside ship. Without charge to the buyer for delivering goods alongside ship.

Finished goods -- Goods which have been fully completed but not yet sold.[16]

Fixed costs -- Costs that remain constant in total for a given period of time despite fluctuations in activity.[17]

F.O.B. -- Free on board. A pricing term indicating that the quoted price for a good includes the cost of delivering the good onto a carrier at the point of shipment without charge to the buyer.

Forward scheduling -- Starting with a known start date and proceeding from the first operation to the last to determine the completion date.[18]

Full absorption costing -- Method of product costing where fixed manufacturing overhead is included in the inventoriable costs plus an allocation of non-manufacturing costs.[19]

-G-

Guaranteed sale -- This is a form of consignment sale. If the product does not move, the manufacturer must purchase it back. Many large retailers use this in their purchase agreements.

-I-

Indirect production costs -- Those costs other than direct production costs which are incident to and necessary for production or manufacturing operations.

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[16] Charles T. Horngren, Cost Accounting a Managerial Emphasis, 5th ed. (New Jersey: Prentice Hall, Inc., 1982), p. 969.

[17] Ibid.

[18] American Production and Inventory Control Society (APICS) Dictionary, 3d ed., 1970 (modified and/or condensed.)

[19] Charles T. Horngren, Cost Accounting a Managerial Emphasis, 5th ed. (New Jersey: Prentice-Hall, Inc., 1982), pp. 964, 970.

-J-

Job order costing -- Products/services readily identified by individual units or batches receiving varying inputs of direct materials, direct labor and indirect costs. Costs are collected according to the job or customer, for example, furniture, aircraft, printing or machinery.

Joint products -- Goods that are simultaneously produced.

- K -

Keystoning -- Doubling cost by a retailer to arrive at a retail price.

Kickback -- The rebate of a portion of the price paid for materials or services to the purchaser or to his agent.

- L -

Landed costs -- Costs incurred to import goods from overseas. The costs include customs processing fees, insurance costs, letters of credit charges.

Lead time -- Time interval between placing an order and receiving delivery. The period of time between the decision to release an order for production and the completion of the first units. Includes wait, move setup, queue, and run time.[20]

Letter of credit -- Short term loans against an established line of credit.

Loading -- Assigning hours of work to work centers in accordance with the available capacity of the work centers.[21]

- M -

Mailer -- See ad slick.

Malquiladora -- Mexican assembly plant located near the U.S.-Mexican border; most production is exported to the United States.

Manufacturer -- One who converts raw materials into a finished product.

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20 American Production and Inventory Control Society (APICS) Dictionary, 3rd ed., 1970 (modified and/or condensed.)

21 Ibid.

Manufacturing burden rate method -- Assigns predetermined rates to only overhead in allocating costs to inventory.

Manufacturing order (shop order) -- A document conveying the authority to produce a specific quantity of a given item. It may also show the materials and machines to use, the sequence of operations, and the due dates that have been assigned by the scheduler.[22]

Margin -- The amount by which the wholesale selling price exceeds manufacturing costs. This is usually expressed as a percentage of cost, that is, the same as profit margin.

Marginal costing -- See variable costing.[23]

Markdown -- A reduction to the cost of raw materials or finished goods carried in inventory or to the usual selling price of finished goods.

Markdown allowance -- An allowance generally negotiated with better customers and based on the likelihood that markdowns from full retail price may need to be taken in order for the retailer to dispose of some of the shipment. Such an allowance may be demanded as a concession by larger retailers, and if this is the case, the terms may appear on their purchase orders.

Mixed costs -- Costs which have both fixed and variable components.[24]

Mixed service costs -- The costs which benefit both production/inventory activities and nonproduction/noninventory.

- N -

Net negative overhead variance -- Excess of total actual indirect production costs over total standard (or estimated) indirect production costs.

Net positive overhead variance -- Excess of total standard (or estimated) indirect production costs over total actual indirect production costs.

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[22] Ibid.

[23] Charles T. Horngren, Cost Accounting a Managerial Emphasis, 5th ed. (New Jersey: Prentice-Hall, Inc., 1982), p. 971.

[24] Ibid., p. 972.

Normal costing -- Allocates costs to products using actual direct materials, actual direct labor, and predetermined factory overhead rates.[25]

North American Free Trade Agreement (NAFTA) -- Agreement creating a free trade area among the United States, Canada, and Mexico. NAFTA went into effect on January 1, 1994.

- O -

Operation costing -- Term used in the manufacture of goods that have common characteristics plus some individual characteristics. Products are specifically identified by batches or jobs or production runs, for example shoes, clothing, or textiles.

Out the back door -- The term used to describe sales made off the books of the company.

Output control -- Dispatching, expediting, and any other follow-up necessary to get scheduled work from a work center or vendor.[26]

Overapplied overhead -- Excess of overhead applied to products over actual overhead incurred.[27]

Overhead -- All costs other than direct materials and direct labor that are associated with the manufacturing process.

- P -

Period cost -- A noninventoriable cost deducted as expenses.[28]

Periodic inventory -- Cost of goods sold is computed periodically by relying on physical counts and not keeping day-to-day records of units on hand or units sold.[29]

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[25] Ibid.

[26] American Production and Inventory Control Society (APICS) Dictionary, 3rd ed., 1970 (modified and/or condensed.)

[27] Charles T. Horngren, Cost Accounting a Managerial Emphasis, 5th ed. (New Jersey: Prentice-Hall, Inc., 1982), p. 973.

[28] Ibid.

[29] Ibid.

Perpetual inventory -- Continuous recordation of additions to or reductions in materials, work in process, and cost of goods sold on a daily basis.[30]

Practical capacity -- Maximum level at which a department or plant can operate efficiently. [31]

Prime costs -- Direct materials plus direct labor.[32]

Principal Business Activity (PBA) Code -- A four digit code used by the IRS to define industries doing business as a partnership or a corporation. This term is used interchangeably with PIA. The returns are self-coded. There are 199 codes for partnerships and 187 codes for corporations.

Principal Industry Activity (PIA) Code -- A four digit code used by the IRS to define industries doing business as a sole proprietorship. The returns are self-coded. There are a total of 183 codes.

Process costing -- Homogenous units not particular to any one customer. Units are mass produced in continuous fashion through a series of production steps called processes.[33] Costs are charged directly to the responsible department or process, for example paint, oil or rubber.

Product costs -- Costs identified with goods acquired or produced for sale.[34]

Production costs -- Those costs which are incident to and necessary for production or manufacturing operations or processes. Costs incurred that add utility to a product.

Profit margin -- The amount by which the wholesale selling price exceeds manufacturing costs. This is usually expressed as a percentage of cost, that is, the same as margin.

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[30] Ibid.

[31] Ibid.

[32] Ibid., p. 974

[33] Ibid.

[34] Ibid.

- R -

Reorder point -- Quantity level at which a new order should be placed.[35]

Routing -- The determination of which machines or work centers will be used to manufacture a particular item. Routing is specified on a route sheet.[36]

Route sheet -- Identifies operations to perform, sequence, and possibly materials, tolerances, tools, and time allowances.

- S -

Scheduling -- Setting operation start dates for jobs so that they will be completed by their due date.[37]

Separable costs -- Costs beyond the split-off point that are not part of the joint process and can be exclusively identified with individual products.[38]

Setup time -- Time required to adjust a machine and attach the proper tooling to make a particular product.[39]

Shop order (manufacturing order) -- A document conveying the authority to produce a specific quantity of a given item. It may also show the materials and machines to use, the sequence of operations, and the due dates that have been assigned by the scheduler.[40]

Split-off point -- The point in production where joint products become individually identifiable.[41]

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35 Ibid., p. 977

36 American Production and Inventory Control Society (APICS) Dictionary, 3rd ed., 1970 (modified and/or condensed.)

37 Ibid.

38 Charles T. Horngren, Cost accounting a Managerial Emphasis, 5th ed. (New Jersey: Prentice-Hall, Inc., 1982), p. 976.

39 American Production and Inventory Control Society (APICS) Dictionary, 3rd ed., 1970 (modified and/or condensed.)

40 Ibid.

41 Charles T. Horngren, Cost Accounting a Managerial Emphasis, 5th ed. (New Jersey: Prentice-Hall, Inc., 1982), p. 976.

Standard absorption cost method -- Assigns predetermined rates to all elements (that is, direct costs and fixed factory overhead) of product cost in assigning costs to inventory without reference to the actual costs incurred.[42] If actual costs differ from the predetermined costs for an element, a variance occurs.

Standard Industrial Classification (SIC) System -- A four digit code developed by statistical agencies (Census, Bureau of Labor) used in defining industries and classifying individual establishments by industry. Codes are assigned by the agency. There are 1,005 codes.

Standard variable costing -- Same as standard absorption cost method except that fixed factory overhead is not included.[43]

Stores requisition -- Form used to charge job cost sheets for direct materials used.[44]

- T -

Theoretical capacity -- Capacity that assumes output production 100 percent of the time.[45]

Trade discounts -- A traditional trade discount is still demanded by many of retailers. The retailer will account for the purchase at cost before the discount and base their selling price on a markup from this figure. The usual mark up is 100 percent or double cost, sometimes referred to as 50 percent. Many manufacturers will mark up their usual selling price to absorb the trade discount. For example, they will sell the equivalent of $92 in goods to the retailer for $100, then allow an $8 trade discount.

Transfer price -- Price charged by one department of a manufacturer for a product or service that it supplies to another department of the same manufacturer.[46]

Transferred-in cost -- In process costing, costs incurred in a prior department that are received in a subsequent department.[47]

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[42] Ibid.

[43] Ibid.

[44] Ibid.

[45] Ibid., p. 977

[46] Ibid.

[47] Ibid.

- U -

Underapplied overhead -- Excess of actual factory overhead over the factory overhead applied to products.[48]

- V -

Variable cost -- Cost which is uniform per unit but fluctuates in total in direct proportion to changes in the related total volume or activity.[49]

Variable costing -- Product costing that charges fixed factory overhead immediately as incurred against the revenue of the period, without assigning it to specific units produced. Also called marginal costing or direct costing.[50]

Volume allowance -- This is much the same as a yearend allowance but is granted based on annual volume only with a threshold figure set before the allowance of any discount. The discount allowed will generally increase as annual volume passes designated amounts.

- W -

Warehouse allowance -- A warehouse allowance is a 2-3 percent discount demanded by many mass merchandisers. It may be accounted for by being indicated as a reduction in price shown directly on the manufacturer's invoice with a reduced net billing or as a chargeback later made by the retailer. The rationale for this allowance is that these retailers re-ship to their stores from a central warehouse, enabling the manufacturer to make a single bulk shipment to the warehouse instead of shipping to the individual stores making up the chain. The amount and terms of the allowance are often printed on the purchase order form.

Waste -- Material which is lost, evaporates, or shrinks in the manufacturing process, or is a residue that has no measurable value.[51]

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[48] Ibid.

[49] Ibid.

[50] Ibid.

[51] Ibid.

Work center -- An area or work station where a particular type of work is performed.[52]

Work in process -- Goods undergoing the production process but not fully completed.[53]

Work ticket -- Shows the time spent on a specific job.[54]

Workload -- Amount of work or backlog in a work center.

- Y -

Yearend allowance -- A yearend allowance is customary with some manufacturers and is usually given only to their best customers, but may also be allowed to some of their older customers regardless of volume. The allowance is generally negotiated at an amount usually equal to 1 to 3 percent of annual calendar year sales. The allowance is taken by the retailer as a credit against his or her outstanding accounts payable in the subsequent year. If a $30,000 total allowance is due the customer, they will generally take the credit at $10,000 a month over 3 months or $5,000 a month over 6 months either by agreement or as a courtesy to the manufacturer.

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52 American Production and Inventory Control society (APICS) Dictionary, 3rd ed., 1970 (modified and/or condensed.)

53 Charles T. Horngren, Cost Accounting a Managerial Emphasis, 5th ed. (New Jersey: Prentice-Hall, Inc., 1982), p. 977.

54 Ibid., p. 978