MSSP

Market Segment Specialization Program

Retail Liquor Industry

Department of the Treasury
Internal Revenue Service

Training 3147-112 (7/97)
TPDS No. 85867B

RETAIL LIQUOR INDUSTRY

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Chapter 1

INTRODUCTION

THE LIQUOR INDUSTRY

Prohibition was repealed with the adoption of the Twenty-first Amendment in 1933. The Amendment also gave each state the right to restrict the importation of alcoholic beverages. Since then, each state has developed their own statutory framework for regulating the sale and consumption of alcoholic beverages within their jurisdiction.

This audit techniques guide was developed in the State of Massachusetts which has its own unique set of laws and regulations regarding the sale and consumption of alcoholic beverages. It should be noted here that any agents auditing a liquor store in a different state should familiarize themselves with that particular state's rules and regulations.

Responsibility for licensing the sale and distribution of alcoholic beverages is shared jointly, although not equally, between municipal, state, and federal authorities. Administration of the Federal Alcohol Act is vested in the Treasury Department in the Division of the Federal Alcohol Administration. In some rare instances, a license is required from only one of these authorities. In most cases, there are dual license requirements.

The industry has a three tiered system for the distribution of its products. The first tier is the manufacturer, the second tier is the distributor or wholesaler, and the third tier is the retailer. The manufacturer sells or grants licenses based on different criteria. The manufacturer may or may not be located in the state. Each state controls what products may be brought into its borders. The distributor or wholesaler sells and distributes the products to the retailers.

The basic merchandise carried by the stores are wine, liquor, and beer. The stores usually carry some, if not all, of the following: cigarettes, soda, chips, drink mixes, cheeses, and spring water. Many upscale stores have extensive wine departments with a wine expert on hand. Some small liquor stores are more of a grocery store than a traditional package store. The information in this guide was developed from the audits of traditional retail liquor stores. The stores audited had liquor sales of at least 85 percent of their gross receipts.

In recent years, total liquor consumption has been steadily declining due to changes in social attitude toward alcohol consumption as well as tougher governmental regulation and enforcement. Because of recent tort cases the usual liquor store will have few assets. The assets will usually consist of equipment needed to operate the business and inventory. Real property is usually held by the shareholder directly or indirectly to protect the assets in a law suit. Many stores may not have liability insurance because the premiums are so high.

THE MASSACHUSETTS LIQUOR INDUSTRY

The Massachusetts liquor industry consists of almost 4,000 liquor stores that are, for the most part, small independently owned stores. The State places many restrictions on these owners. Individuals may only own three licenses at a time. These licenses cannot be owned by an individual who is not a resident of the State or by an out of State corporation. However, a corporation may have out of State shareholders. A few larger stores operate as franchises. The owner will usually have two store licenses and one license for a warehouse. The warehouse provides liquor for its own stores and other stores paying or participating in the franchise operation.

The State places many restrictions on these stores; such as, the hours and days they may be open, who they may sell their product to, who they can purchase this product from and how they may transport it. The State allows the stores to be open Monday through Saturday and selected holidays. Stores on the New Hampshire border can be open on Sundays. They cannot open before 8:00 a.m. and must close by 11:00 p.m. These stores cannot sell to other liquor stores, bars, and any other entity set up like a bar, that is, Elks club etc. The State also restricts their ability to purchase liquor products from anyone other than a liquor distributor located in the State of Massachusetts. The State requires different types of licenses in order for a business to sell or distribute liquor products. For example, a Section 22 license is required in order to transport liquor, wine, and beer products. See Exhibit 1-1 for a list of licenses issued by Massachusetts.

A price book, ***The Massachusetts Beverage Price Journal***, published monthly, lists the purchase price for all liquor products sold in the State. The wholesalers must sell the product to the liquor store at this price. Larger stores receive free goods or cash credits for large quantities purchased. These are acceptable practices if reported to the State. However, Massachusetts will not allow a store to sell alcoholic beverages below cost. The State has investigators who check on these transactions.

INFORMATION GATHERING

The New England District established a team of revenue agents to gather information and perform examinations. Because this guide was developed based on audits performed in Massachusetts, there are references to Massachusetts regulations and industry operation/practices in this guide. However, you will probably find the retail liquor industry in your state operates much like that of Massachusetts.

The project team gathered information from many different sources. One source of information was the Alcoholic Beverage Control Commission (ABCC). They provided the team with information related to owning and operating a liquor store in Massachusetts. The ABCC or your state regulatory agency can provide information regarding licenses issued and rules and regulations regarding purchasing and selling of alcohol.

In the State of Massachusetts, most liquor stores have lottery sales. Your state lottery commission is a potential source of information to verify the reported lottery income and test the store's internal controls. See Chapter 4 for more information on lottery income.

In Massachusetts, there is a 5 cent deposit on most beer and soft drink bottles. Depending on whether bottle/can redemption is required in the state, another source of information would be the bottle redemption centers. See Chapter 4 for more information regarding bottle redemption income.

The industry has several associations. It has a national organization that has a large membership. In addition, many states have their own associations. In Massachusetts one of these is the Massachusetts Package Stores Association. This association's primary purpose is to work on State legislation that affects the liquor industry. Approximately 30 percent of the liquor store industry in the State are members of this association. The association also offers group benefits for its members; such as, health insurance plans, workers compensation packages, credit card programs, and discounts on paper goods (register tapes etc.). In addition, the association issues membership bulletins regularly to keep its members informed of current issues.

The alcoholic beverage regulatory agency, in your state, can be a good source of information. They should be able to provide you with the number of licenses held and what reporting requirements there are. There are also local guides that may be of assistance. In Massachusetts, for example, the Massachusetts Continuing Legal Education group publishes a book called ***Entertainment and Alcoholic Licensing***. This book is an excellent guide on all the legal requirements of owning and operating a liquor store.

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Exhibit 1-1

TYPES OF LICENSES IN MASSACHUSETTS

(Outside of Massachusetts, contact your local state licensing authorities for information)

On-premises Consumption (Pouring Licenses)

Section 12 provides for licenses authorizing the sale of alcoholic beverages to be drunk on the premises. The license may be for sale of all alcoholic beverages or for wine and/or malt beverages only. The license is granted by the local board and requires ABCC approval.

Types of Section 12 Licenses:

Common Victualler (Restaurant), Innholder (Hotel), Tavern, Club and General On-premises (Sale of Alcohol without food).

Section 13 authorizes licensing of alcoholic beverage service aboard railroad cars, airplanes, and ships. These licenses are issued by the ABCC.

Section 14 authorizes special licenses for the sale of alcoholic beverages at indoor or outdoor activities. Normally these licenses are restricted to the sale of wine and malt beverages. These licenses are issued by the local authority.

Off-Premises consumption (package Licenses)

Section 15 authorizes sales for off-premise consumption (that is, package stores). No person or combination may own more than three package stores total, two in any city, or one any town. Section 15 licenses are issued by the local authority and require ABCC approval.

Section 19b (farmer-Winery) and Section C (farmer-Brewer) licenses may sell their own products for off-premises consumption.

Section 29 Pharmacists may sell alcoholic beverages on prescription. A Certificate of Fitness is issued by the Board of Registration in Pharmacy.

Section 30A authorizes licensing of pharmacist to sell alcoholic beverages without prescription. Such licenses are required to keep a record of each sale under the provisions of Section 30E. The license is issued by the local board and requires ABCC approval.

Other licenses and permits issued by the ABCC

Section 18: Wholesalers and importers. No alcoholic beverages may be brought into Massachusetts for resale except by a Section 18 license.

No Section 18 or Section 19 license may hold an interest in a Section 12 license, see section 12. Note that a wholesaler can own a package store (Section 15), indeed, a number of Section 15 licensees sell wine imported under their own Section 18 license.

Section 18A: Selling agents of out of State manufacturers and importers (Brokers).

Section 18B: Certificates of Compliance for out of State suppliers. Allows certificate holders' product to be sold to, and imported into Massachusetts by a Section 18 licensee.

Section 19: Licenses for the Manufacturers of Alcoholic beverages.

Section 19A: Salesman's permit required for representatives of Sections 18, 19, 19b, and 19C licensees.

Section 19B: Farmer-Winery license. Allows manufacture, wholesale and retail package sale, and, with local approval, on-premises service of wine.

Section 19C: Farmer-Brewer license. Allows manufacture, wholesale and retail package sale, and with local approval, on-premises service of malt beverages.

Section 20: Storage Permits for manufacturers and wholesalers.

Section 20A: Storage Permits for warehouse operators.

Section 22: Transportation Permits. Required for any vehicle used to transport alcoholic beverages belonging to a licensee.

Chapter 2

INDUSTRY PRACTICES

INTRODUCTION

In the retail liquor store industry there are many common practices. These practices are explained below to assist the examiners in familiarizing themselves with the industry.

ACCOUNTING SYSTEMS

The retail liquor stores keep books and records that are similar to most small retail stores. The smaller stores maintain their records using a one write system. The larger stores maintain a general ledger, a cash receipts/sales journal and a cash disbursements/purchases journal. The larger stores also maintain other schedules such as aged receivables and aged payables. See Exhibit 2-1 for a flow chart of the records that are common to the retail liquor industry.

BEER SALES

Beer is normally purchased in a package called a suitcase consisting of 24 cans. The liquor stores purchase plastic rings from the wholesalers and breakdown the suitcases into six packs by placing the cans in the rings. Also, boxes for the six packs can be bought from the wholesalers. By doing this the gross profit on the sale of the beer cans will increase since the sales price for individual cans, six packs and cases differ. See Chapter 4 for discussion of gross profit on beer products.

BOTTLE REDEMPTIONS

In Massachusetts, there is a 5 cent bottle deposit on most bottles and cans, purchased and sold. The State requires the wholesalers to pay 2.25 cent plus the bottle deposit of 5 cent to the liquor stores redeeming the bottles. In addition, the State requires the wholesalers to provide pick up services for the empty bottles redeemed. Some wholesalers pick up the bottles themselves and some hire a recycling company to pick up the bottles. If the wholesaler uses a recycling company the liquor store receives the bottle redemption income from the recycling company. See Chapter 4 and Chapter 8, Issue 1 for more information.

LOTTERY SALES

Many retail liquor stores sell lottery tickets to bring customers into their stores. There are three categories of lottery games in Massachusetts. These lottery games are:

1. Lotto games - Megabucks, Mass Millions, Mass Cash and The Numbers Game

2. Instant games - $1, $2 and $5 instant tickets

3. Keno

In Massachusetts, all sales agents receive a 5 percent commission on all lottery sales. In addition, they receive a 1 percent bonus on all prizes paid under $600. The agents also receive other bonuses on higher tier prizes over $600 and on yearly ticket renewals. Each State may have its own lottery system.

See Chapter 8, Issue 2 for more information.

CIGARETTES AND OTHER INCOME ITEMS

The retail liquor stores sell primarily liquor products, however, they do sell other items. These consist of seasonal items, glassware, snack foods, cigarettes, etc. Cigarettes are displayed on racks based on brand. A commission may be paid to the store based on brand placement. The commission is small and is usually only given for top shelf space.

FINE WINE DEPARTMENTS

Many larger retail liquor stores have fine wine departments. These departments market toward the sophisticated wine customer. There is a wine director who is responsible for fine wine purchases. The director is also available for consultations with the customers to help them select the appropriate wine. The wine director often publishes a wine newsletter for store customers. These newsletters provide information on the best wines available and on promotions in the stores. The wine directors rely on magazine articles, wine tasteings, and other sources for the information they provide.

ADVERTISING

Advertising is done at national and local levels. The manufacturers will advertise their product nationally on television and in magazines. The retail liquor stores advertise primarily in the local and statewide newspapers. Some will do radio advertising. Often, several stores will get together and place one advertisement for sale items. The newspaper will bill a store and the other stores will reimburse that store for their share of the expense. Most of the larger stores advertise sales every week.

SCANNING REGISTERS

Scanning cash registers are a new item in the retail liquor stores in Massachusetts. Due to the cost involved, most stores did not find it cost effective to purchase this type of cash register. These registers offer a perpetual inventory system by reading a UPC label at point of sale. It provides increased controls on the store inventory and on the store sales. It also can be used to assist in the purchasing needs of the store.

SECURITY

Many store owners find that their biggest security problems are with their employees. There are several ways the stores "keep an eye" on their employees. One of them is the use of surveillance cameras. Another type of security used is undercover shoppers who watch he cashier as they ring in sales. During the busy seasons, Christmas and New Years, stores use police details to protect against shoplifting. Since this is a cash business most stores have some type of security system in place.

DELIVERIES

In Massachusetts, some retail liquor stores deliver to customers. Liquor cannot be transported without a license (Section 22 - Transportation Permit). One license is required for each delivery vehicle. The delivery vehicle is often a van or a vehicle that the owner of the store drives.

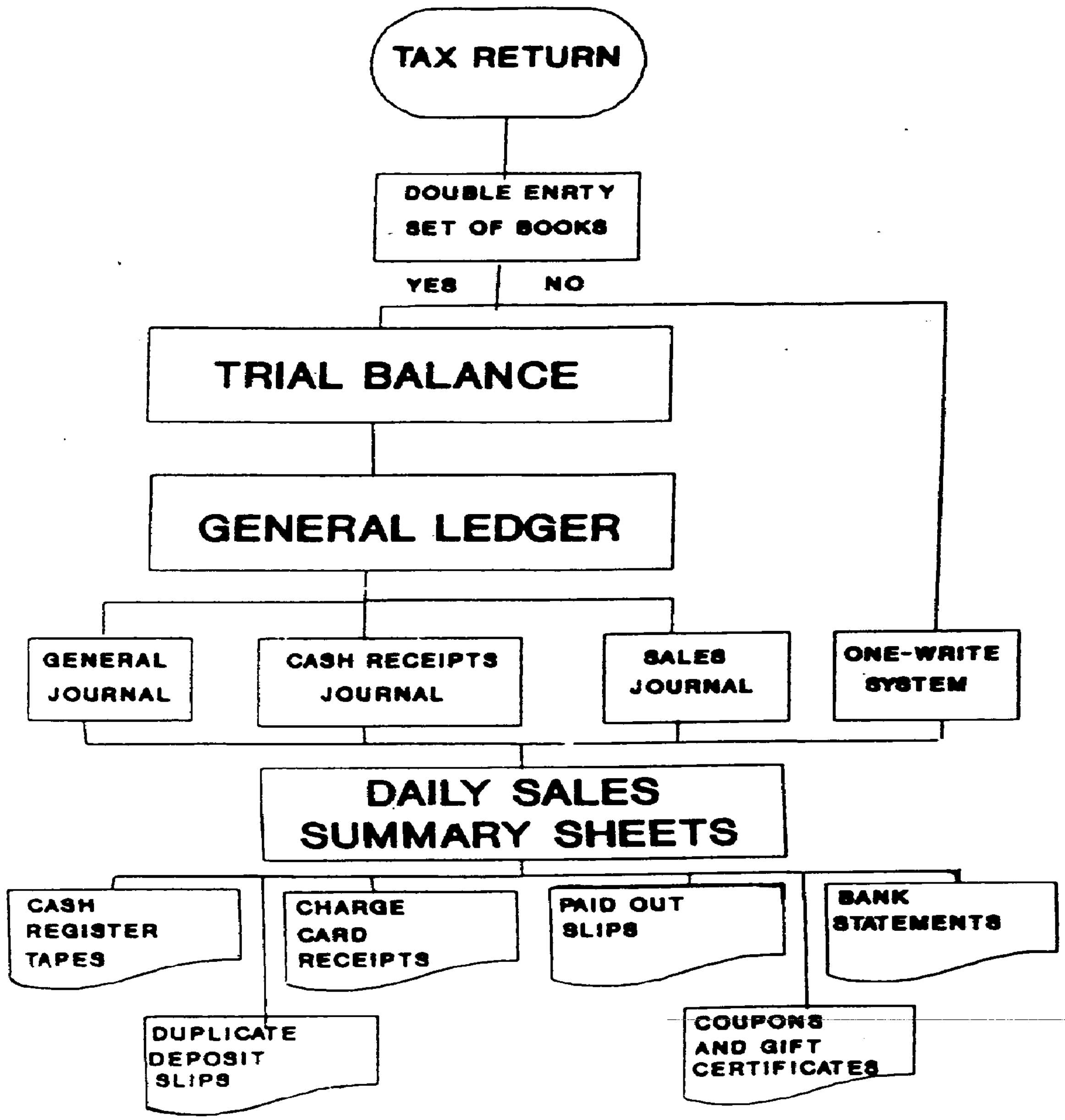
CUSTOMERS ON ACCOUNT

Most of the retail liquor stores give credit to customers who frequent their stores. There are several ways to account for these sales. Some stores ring the sale into the cash register at the time of the purchase, some accumulate sales slips and ring them in once or twice a month, and some stores ring in the sale at the time of payment. The method of accounting for these sales should be determined during the initial interview. The store should record the sales on consecutively numbered sales invoices. In addition, if the sales are rung in the cash register at the time of payment there should be a year end adjusting entry bringing the receivables into income.

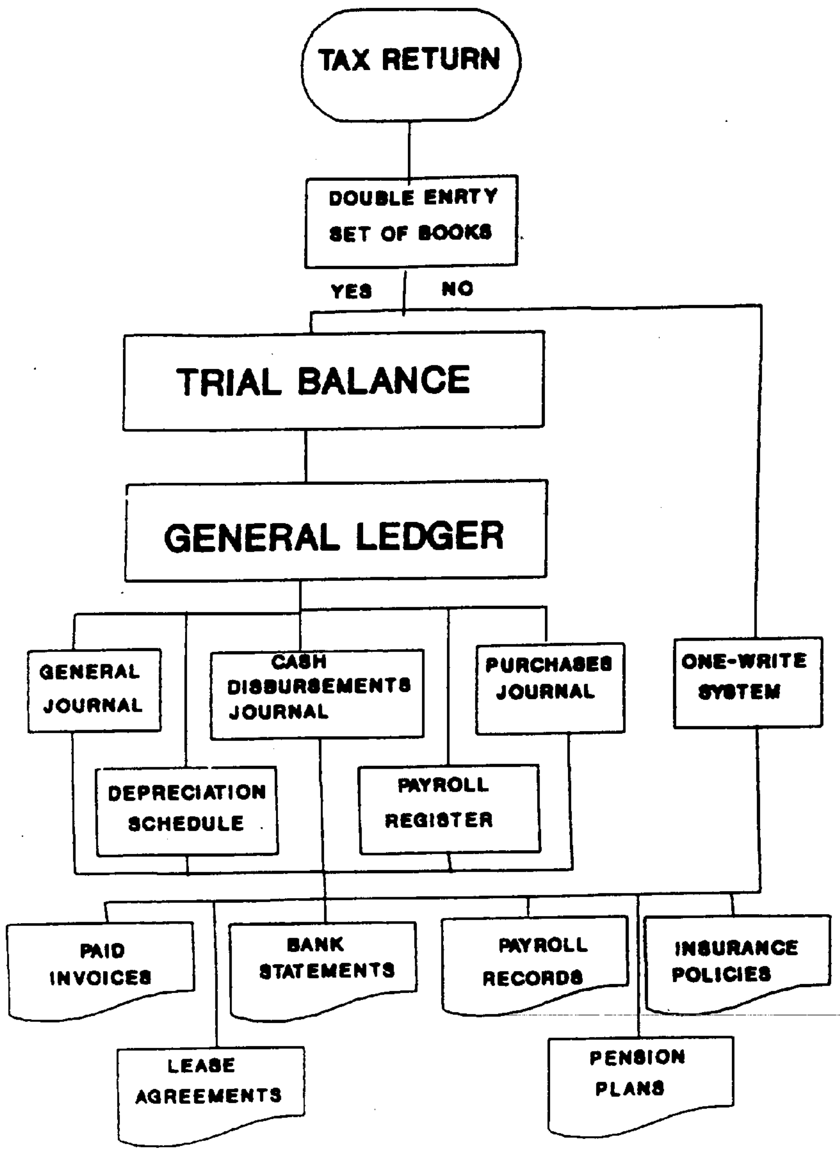
BEER COOLERS

It is important to note that normally the largest asset of a retail liquor store is the beer cooler. Large maintenance and repair expenses may be found to keep the cooler in good working order.

The Retail Liquor Industry Sales Flow Chart



The Retail Liquor Industry Expense Flow Chart



Chapter 3

PRE-AUDIT ANALYSIS

INTRODUCTION

The team used various tools in their pre-audit analysis. These tools assisted the agents in determining the scope of the examination. The following is a description of these tools.

COMPARATIVE ANALYSIS

The team used three methods of data comparisons to evaluate the audit potential of various accounts. The analyses encompassed both a balance sheet and income statement approach. These multiple year analyses illustrated the fluctuations in various accounts and served as a valuable tool in formulating an examination strategy.

The "Balance Sheet Comparative Analysis" illustrates the account fluctuations over a 3-year period. Using his analysis the examiner can identify the accounts that had the greatest change over a 3-year period.

The "Asset and Liability Analysis" illustrates comparisons with the industry averages. Research material containing industry financial data should be available at most public or university libraries. Examples of financial data resources include the ***Almanac of Business and Industrial Financial Ratios*** published by Prentice Hall and the ***Robert Morris Associates Annual Statement Studies***

The sample cases worked by the team illustrated that the "Asset and Liability Analysis" was a useful tool in identifying issues. For example, a tax return lacking economic reality due to the taxpayer's skimming of cash could be identified by a multiple year analysis of the fixed asset account together with interest expense. The increase in assets without additional indebtedness and with insignificant taxable income would lead the examiner to include multiple indirect methods as part of the pre-examination plan.

The "Expenses as A Percentage of Sales Analysis" uses an income statement approach to compare a taxpayer's expenses to industry averages. This analysis may illustrate that a taxpayer's gross profit ratio is significantly below the industry average.

See Exhibit 3-1 for an example of each analysis.

INFORMATION DOCUMENT REQUEST

The team developed the Information Document Request appearing in Exhibit 3-2 to be used with the initial appointment letter. These items were present on most examinations and, therefore, should be requested at the commencement of the examination. The questions addressing the lottery would vary by state. See Chapter 4 for a discussion of the Massachusetts State Lottery.

INITIAL INTERVIEW

The examinations identified specific issues in the operation of a retail liquor store. Through the course of these examinations, the team developed an "Initial Interview Questionnaire" to address these issues. See Exhibit 3-3 for a copy of the questionnaire.

Exhibit 3-1 (1 of 3)

BALANCE SHEET COMPARATIVE ANALYSIS

T/P ENTITY TYPE EIN
TAX YEARS :

****

	YEAR 1	YEAR 2	YEAR 3	YR2 LESS YR1	YR3 LESS YR2
ASSETS					
1 CASH	0	0	0	0	0
2 RECEIVABLES	0	0	0	0	0
2 b BAD DEBT ALLOW.	0	0	0	0	0
2 NET RECEIVABLES	0	0	0	0	0
3 INVENTORIES	0	0	0	0	0
4 GOV'T OBLIGATIONS	0	0	0	0	0
5 TAX EXEMPT SEC.	0	0	0	0	0
6 OTHER CURRENT ASSETS	0	0	0	0	0
7 LOANS TO SHAREHOLDER	0	0	0	0	0
8 MORTGAGE AND R/E LOA	0	0	0	0	0
9 OTHER INVESTMENTS	0	0	0	0	0
10a -DEPRECIABLE ASSETS	0	0	0	0	0
10b-LESS DEPRECIATION	0	0	0	0	0
10 -NET DEPRECIATION	0	0	0	0	0
11a-DEPLETABLE ASSETS	0	0	0	0	0
11b-DEPLETION	0	0	0	0	0
11 -NET DEPLETION	0	0	0	0	0
12 LAND	0	0	0	0	0
13 NET INTANGIBLES	0	0	0	0	0
14 OTHER ASSETS	0	0	0	0	0
15 TOTAL ASSETS	0	0	0	0	0
LIABILITIES AND STOCKHOLDERS' EQUITY					
16 ACCTS PAYABLE	0	0	0	0	0
17 MTGS/NOTES <1YR.	0	0	0	0	0
18 OTHER CURRENT LIABS.	0	0	0	0	0
19 LOANS FROM S/H	0	0	0	0	0
20 MTGS/NOTES >1YR	0	0	0	0	0
21 OTHER LIABILITIES	0	0	0	0	0
22 PREFERRED STOCK	0	0	0	0	0
22 COMMON STOCK	0	0	0	0	0
22 TOTAL STOCK	0	0	0	0	0
23 PAID-IN SURPLUS	0	0	0	0	0
24 RET.EARNINGS/APPROP	0	0	0	0	0
24 RET.EARNINGS/UNAPPRO	0	0	0	0	0
26 LESS TREASURY STOCK	0	0	0	0	0
26 TOTAL LIABS & EQUITY	0	0	0	0	0

ASSET AND LIABILITY COMPARISONS TO INDUSTRY AVERAGES

T/P NAME

BALANCE SHEET CATEGORY	TY1	TY2	TY1	TY2 RATIO	IND RATIO	TY1 AVG	TY2 VARVAR
TOTAL ASSETS					100.0%		
CURRENT ASSETS (AS A PERCENTAGE OF TOTAL ASSETS)							
CASH					11.7%		
ACCOUNTS REC.					0.0%		
INVENTORIES					39.0%		
OTHER CURRENT ASSETS					0.0%		
FIXED ASSETS (AS A PERCENTAGE OF TOTAL ASSETS)							
LAND, BUILDING & LEASEHOLD IMP.					0.0%		
EQUIPMENT					6.1%		
OTHER FIXED ASSETS					0.0%		
TOTAL LIABILITIES					100.0%		
LIABILITIES (AS A PERCENTAGE OF TOTAL LIABILITIES)							
ACCOUNTS PAYABLE					13.0%		
SHORT TERM BANK LOANS					0.0%		
OTHER CURRENT DEBT					12.4%		
RATIOS							
SALES FOR YEAR							
SALES/INVENTORY					10.3		
SALES/TOT ASSETS					3.9		
PROFIT/TOT ASSETS					8.4		

EXPENSES AS A PERCENTAGE OF SALES COMPARISON

T/P NAME

CATEGORY	TY1	TY2	TY1 RATIO	TY2 RATIO	IDN AVG	TY1 VAR	TY2 VAR
--------------	------	------	--------	--------	------	------	-------
GROSS RECEIPTS							
			EXPENSES				
COST OF GOODS SOLD					77.4%		
GROSS PROFIT					22.6%		
GENERAL & ADMIN.					19.9%		
OPERATING PROFIT					2.8%		
INTEREST EXPENSE					0.4%		
DEPRECIATION					0.6%		
PROFIT BEFORE TAX					1.8%		
			OTHER EXPENSES				
LABOR					7.0%		
ADVERTISING					0.5%		
TRAVEL & ENTER.					0.1%		
RENT					2.9%		
INSURANCE					0.9%		
OFFICERS COMP.					5.1%		
REPAIRS					0.4%		
TAXES					1.8%		
PENSIONS					0.2%		
OTHER EXPENSES					10.3%		

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Form 4564 Rev. 6/88	Department of the Treasury Internal Revenue Service **INFORMATION DOCUMENT REQUEST**	Request Number
TO: Name of Taxpayer and Co. Div. or Branch Please return Part 2 with listed documents to requester identified below.		Subject SAIN No. | Submitted to: Dates of Previous Requests

Description of Documents Requested

1. FINANCIAL STATEMENTS
2. TRIAL BALANCE AND ADJUSTING ENTRIES (AT YEAR END AND ANY ADJUSTING ENTRIES MADE DURING THE YEAR)
3. ALL LEDGERS AND JOURNALS MAINTAINED, CHART OF ACCOUNTS
4. PURCHASE INVOICES AND DAILY SALES SHEETS
5. TAX RECONCILIATION WORKPAPERS GROUPING OF ACCOUNTS
6. BANK STATEMENTS AND CANCELED CHECKS
7. CASH REGISTER TAPES
8. LOTTERY SALES COMMISSION STATEMENTS: FORMS 1099, SR61, SR31, AND THE AGENT ISSUANCE AND SETTLEMENT FORMS (MASSACHUSETTS ONLY)
9. CORPORATE MINUTES
10. PRIOR FEDERAL AND STATE AUDIT REPORTS, IF APPLICABLE
11. COPIES OF PRIOR ANS SUBSEQUENT YEAR FEDERAL INCOME TAX RETURNS INCLUDING AMENDED RETURNS
12. COPY OF STATE TAX RETURN
13. COPY OF EMPLOYMENT TAX RETURNS, INCLUDING FORMS W-2, W-4, 1099
14. RELATED RETURNS (FORMS 1065, 1041, 1120, 1120S, ETC.)
15. OFFICER/SHAREHOLDER INDIVIDUAL TAX RETURNS
16. FORM 5500 FILED FOR PENSION PLAN, IRS DETERMINATION LETTER, CANCELED CHECK FOR THE CONTRIBUTION PAYMENT
17. COPIES OF LICENSES HELD BY THE CORPORATION

Information Due By__________ At Next Appointment [ ] Mail In [ ]

FROM:	Name and Title of Requester	Date
	Office Location	

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INITIAL INTERVIEW QUESTIONNAIRE

(Note: This list is not all inclusive, but examiners can use this as a guide to prepare for their interviews.)

BACKGROUND:

1. Any prior audits? What were the results?
2. How long have you been in business?
3. Always at this location?
4. Who owns the business?
5. How many licenses do you have? How much did you pay for them? Other store locations and names.
6. Who owns the real estate? Is there a lease agreement?
7. Ownership in any related entities? Any transactions between them?
8. Any family members work for the company? What are their responsibilities?
9. How many other employees? What are their responsibilities?
10. Does the company own any vehicles? How many? Who drives them? Personal use accounted for?
11. Any benefits provided to employees? (Health insurance, pension, etc.)
12. Do you purchase wine futures? How are they accounted for? Do you sell wine futures to customers?

FINANCES:

1. What bank accounts are there and what is their purpose?
2. Who prepares deposits? Who makes deposits?
3. Cash on hand?
4. Do you have any loans payable or receivable? With whom? For what?
5. Who has authority to sign checks?
6. Who reconciles the bank statements?

BOOKS AND RECORDS:

1. What type of records do you have? (Income, expense)

2. Who makes the entries?

3. How are gross receipts on the tax return arrived at? (Sales, lottery commissions)

4. How many cash registers do you have? How many are running at the same time?

5. Who reconciles the register tapes?

6. How are cash payouts accounted for?

7. How are over and under amounts from the register reconciliations accounted for?

8. Do you sell lottery tickets? How is the income accounted for? Do you maintain daily lottery commission summaries? How is the lottery expense determined?

9. Do you accept credit cards? Which ones?

10. Do you accept checks? Do you cash checks?

11. How do you record consignment or commission income for counter space?

12. What is the markup percentage applied to beer; wine; liquor?

13. What percentage of total sales is beer; wine; liquor?

14. How are bottle redemptions handled?

15. How is inventory accounted for?

16. Who are your primary vendors? What are the payment terms? Discounts?

17. How are free goods and purchase credits accounted for?

18. How do you account for personal use of the store products?

Chapter 4

INCOME EXAMINATIONS

INTRODUCTION

Retail liquor stores are cash intensive businesses. Therefore, the examiner should consider performing an in-depth probe for income. The following is a brief discussion of income items identified during the team's examinations.

SALES BEER, WINE AND LIQUORS

Description

Generally, liquor stores in Massachusetts will sell beer, wine and liquor. However, some stores may sell only beer and wine. Usually, each product is marked up separately and the markup is based on the owner's expertise and knowledge of the items. Massachusetts State law does not allow a liquor store to sell an item below cost. Many liquor stores also sell cigarettes, snacks, and mixes.

Books and Records

Daily cash receipts are recorded on a daily sales sheet. The z total on the cash register tape is generally the sales figure recorded. The z total is the total amount of sales for the day by item and is generally run at the end of the day. Also recorded on the daily sales sheet are cash paid out for bottles and other items, bottle deposits, and the net bank deposit. The daily sales sheets are posted to a weekly or monthly summary. This summary is usually in a spreadsheet format and contains the totals from the daily sales sheets. The summaries are posted to a trial balance or a general ledger at year end and finally to the tax return. Items such as commission income and bottle redemption income, are separate items on the daily sales sheets.

Issues

Income issues may be caused by an inaccurate posting from the daily sheets to the summaries or from the summaries to the trial balance or tax return. Cash paid out may not be included in the computation of gross receipts if the taxpayer uses a bank deposit method to determine income.

Another issue the team encountered was employee embezzlement. Many store owners stated that this was one of their biggest problems. It is usually an employee that has been with the store for a length of time and has learned their system. The agent will need to determine whether the embezzlement was of cash or inventory. If it is inventory, no corporate adjustments will be necessary since the year end inventory should have taken this into account. If cash was taken, the agent will need to determine whether it was taken prior to or after being rung into the register. Employee embezzlement will affect the store's gross profit percentage. The embezzlement income is taxable to the employee.

Audit Techniques

Besides the traditional indirect methods, transaction testing should be conducted. The cash register tapes should be reconciled to the daily sales sheets. The daily sales sheets should be reconciled to the weekly or monthly summaries. The summaries should be reconciled to the trial balance and finally to the tax return. This test should be conducted in reverse order from the tax return to the cash register tapes, as illustrated in the flow charts in Exhibit 2-1.

The taxpayer's net deposit recorded on the daily sales sheets should be reconciled to sales on the cash register tape z totals, with adjustments for cash paid out.

All adjusting entries that affect sales should be scrutinized to ensure they are valid.

The liquor store's gross profit percentage should be compared to the national averages in Exhibit 3-1. Substantial variances from the national averages may require further scrutiny at the corporate or shareholder level.

For closely held corporations, examinations of the shareholders' tax returns should be considered to ensure funds were not diverted. An examination should be conducted if the liquor store has weak internal controls.

WINE FUTURES

Description

Wine futures are offered to store customers as a "forward contract." A "forward contract" is generally defined as a contract entered into between two parties for delivery of specified property at a fixed price at a future delivery date.

Issues

Whether advanced payments should be included in income when received or deferred until the wine is delivered to the customer? In most case the store will receive an advanced payment for these contracts. The general rule of law is if the advanced payment is not refundable it is includible in income in the year of receipt under IRC section 451 unless it may be excluded under Rev. Proc. 71-21 or some other section of the Code.

Audit Techniques

To make a correct determination, the examiner will need to examine the terms of the specific wine future and the nature of the transaction. Specifically, consider whether the advanced payments is a full or partial payment for the anticipated wine acquisition or sale. Scrutinize the terms of the contract, specifically focusing on any liquidated damages provisions indicating under what circumstances the prepayment may or may not be refunded.

BOTTLE REDEMPTION INCOME

Description

Massachusetts State law requires a 5 cent deposit for all bottles and cans sold by retail and wholesale establishments. The wholesaler will collect the deposit on sales to the retailer. The retailer will then collect the deposit from the customer.

Customers who turn in empty cans and bottles to a retailer will receive either cash or a credit on a future purchase. The retailer will then return the bottles and cans to a wholesaler or to an independent redemption company. The retailer will receive a 7.25 cent purchase credit or cash payment for every bottle and can returned.

Books and Records

Generally, the daily sales sheets reflect bottle redemption income. The daily sales sheets will show both the deposits collected and the cash paid out for bottles and cans turned in. These sales sheets should reconcile to the bank deposits and the cash register tapes.

The bottles turned into the wholesaler should be accounted for as a credit on a subsequent purchase invoice. If bottles and cans are collected by a redemption company, the liquor store will receive a check for the redemption income.

Issues

The major issue involved in bottle redemption is income received from independent bottle redemption companies. Liquor stores that receive bottle redemption checks may not deposit the check into the business account or may cash the check out of the daily cash receipts.

A secondary issue is the improper recording of cash paid out. If bank deposits are used to determine income, cash paid out must be added to total deposits to arrive at gross receipts.

See Chapter 8, Issue 1.

Audit Techniques

When examining the bottle redemption issue, the daily sales sheets should be reconciled to the cash register tapes and the tapes to the sales sheets.

The deposit slips should be scanned for large checks deposited that might indicate the taxpayer is cashing redemption checks out of the cash register and not reporting their receipt. When conducting a bank deposit analysis all cash paid out should be added to deposits to arrive at gross receipts.

LOTTERY INCOME

Description

The lottery in Massachusetts consists of three games: Lotto Games, Instant Games, and Keno. The liquor store receives a 5 percent commission on all lottery sales. In addition, they receive a 1 percent bonus on all prizes paid under $600. The bonuses paid on higher tier prizes, over $600, may be different.

Each sales agent should keep a separate bank account for lottery transactions. This account should receive deposits for daily sales. The lottery then withdraws from the account the amount due them, net of commissions and bonuses. Often, the sales agent deposits only the net amount due to the lottery into this account.

Books and Records

In Massachusetts, the lotto games and keno have a weekly sales report called SR61. The SR61 report, generated by the sales agent's lottery machine, shows sales, commissions, bonuses, and claims for the week.

The instant games have an "Agent Issuance and Settlement Form" and a weekly sales report called SR31. The lottery representative prepares the "Agent Issuance and Settlement Form" every 2 weeks. The Form reconciles the sales agent's inventory held on a consignment basis. The SR31 reconciles the games sales, commissions, and bonuses.

Issues

The major issue is the improper accounting of lottery commission and bonuses for fiscal year taxpayers.

See Chapter 8, Issue 2.

Audit Techniques

Third party contacts should be made with the lottery commission to verify bonuses and commissions earned. For calendar year taxpayers, the Form 1099 issued by the State should be reconciled to lottery income reported. See Exhibit 4-1 for a sample of a cover letter and an Information Document Request that would be sent to State Lottery Commission.

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Chapter 5

COST OF GOODS SOLD

INTRODUCTION

Generally, cost of goods sold is the largest deduction on a retail liquor store's tax return. Therefore, consider an in-depth examination of this item. The following is a brief discussion of the items affecting cost of goods sold.

PURCHASES

Description

The most common items found under the category of purchases are as follows: beer, wine, liquor, cigarettes, nuts, chips, pretzels, soda, candy, etc. Beer, wine, and liquor purchases make up most of the expense. Most retail stores deal with four to five major suppliers and several smaller suppliers. A less common purchase item is wine futures. This is a contract to purchase wine to be delivered at a later date and at a predetermined price.

Books and Records

The smaller stores usually maintain their books using a one-write system. The larger stores maintain accounts payable and purchase journals. Most stores maintain daily records on a cash basis and make adjusting entries for accruals. Invoices, canceled checks, and paid out slips should be available to tie to the book entries. Wine futures may be evident on the balance sheet and should be supported by written contracts.

Issues

The general rule is that a liquor stores cannot include in inventory the amount paid for wine futures until they receive the wine. The amount paid should be reflected as an asset on the balance sheet. Given the recent promulgation of regulations under IRC sections 446 and 1221 concerning the tax treatment of hedging transactions, agents finding this issue on a return should make a referral to the financial products group in their district.

The team used two types of confirmation letters to confirm purchases as reported on the returns examined. The confirmations resulted in no adjustments.

Audit Techniques

IRM 4231 text 5(10)2.1 outlines audit techniques to use when examining the purchases account. The following is an excerpt from the Manual as it applies to retail liquor stores:

1. Review cut-off date. Determine if year end purchases are recorded in the proper accounting period.

2. Determine owner consumption.

3. Scan the purchases column in the cash disbursements book and look for items unusual in amount or for vendors not associated with the products sold by the taxpayer.

4. Review entries in the general ledger. Note and verify entries which originate from other than usual sources.

5. Test check recorded amounts with vendor's invoices and canceled checks. Look for personal expenses, capital expenses and fictitious or duplicate invoices.

6. If purchases are made from a related entity, review a representative number of transactions to determine if the following are present: (a) price in excess of fair market value, (b) excessive rebates and allowances and (c) goods and services not received.

7. Ascertain if merchandise, discounts, prizes, trips, etc., were received as a result of volume purchases.

8. Ensure bottle credits issued by wholesalers are accounted for correctly.

During the initial interview the taxpayer should be asked whether the store deals in wine futures. A pre-audit of the balance sheet should indicate the presence of this issue. Request all contracts and determine if the taxpayer is accounting for the futures correctly.

INVENTORY

Description

All retail liquor stores should have an inventory. The smaller ones usually take a physical count at year end. Some larger stores with scanner registers will have a perpetual computerized count. Inventory should be valued at the lower of cost or market. Some stores take inventory at retail and make year end adjustments to bring inventory value to cost. The method to bring the retail amount to cost varies and is based on the owner's expertise. Some stores may not have a system for taking inventory and the amount is based on an eyeball review of what was in the store. This method is not permissible.

Books and Records

The IRM states that taxpayers should have inventory count sheets and computerized taxpayers should have computer run inventory sheets. In Massachusetts, there is a beverage price journal which lists the purchase price of liquor products purchased in the State. Each individual product usually has its own mark-up percentage. Therefore, a reconstruction of inventory based on a mark-up percentage may be difficult.

Issues

An issue found during examinations of small retail stores that filed Form 1120A was the omission of inventory from the cost of goods sold calculation. The cost of goods sold section on the return requires the taxpayer to only fill in the purchases amount and then refers the taxpayer to the instruction booklet to account for the beginning and ending inventory. As a result, the taxpayer deducts purchases as cost of goods sold without adjusting for inventory.

Another issue is the failure to keep any records to document ending inventory. Many owners state they know exactly what is in their store at any time just by looking around and fail to take a physical year end inventory. Also, some taxpayers taking inventory at retail use an arbitrary mark-up percentage and apply it across the board to all items in their inventory.

Audit Techniques

IRM 4231 text 5(10)2.2 requires minimum checks when inventory is an examined item. The following are the checks that should be made:

a. Verify that the method of inventory valuation conforms to a prescribed method.

b. Compare inventory balances with prior and subsequent year returns and the taxpayer's books.

c. Check for unauthorized changes from cost to cost or market.

d. Check for gross profit percentage variations.

e. Check notes to financial statements of independent auditors.

f. Ensure year end purchases are included in ending inventory.

g. Determine if there have been any inventory write-downs to below cost.

Compare the cost of goods sold deduction, on the face of the return, to the purchase amount entered in Part II, line 5a. If purchases and cost of goods sold are the same, then the taxpayer did not consider beginning and ending inventory balances when computing cost of goods sold. Most taxpayers in this situation have inventory balances on the balance sheet which may be used to make the adjustment. This is a change in accounting method.

See Chapter 8, Issue 3.

263A UNIFORM CAPITALIZATION RULES

Description

IRC section 263A requires any retail establishment with an average of gross receipts over $10 million over the past 3 years to capitalize certain indirect expenses into ending inventory. Most liquor stores do not meet the gross receipts test. However, be aware of this section when examining any retail establishment.

Books and Records

There should be an adjusting entry for the amount determined under IRC section 263A. There also should be work papers with the computation to support the adjustment. The accounts payable or cash disbursements book along with the general ledger will document the dollar amounts on the computation work paper.

Issues

Some liquor stores are required to calculate the IRC section 263A adjustment in determining ending inventory. Those that are may not be calculating it at all or may be applying it incorrectly.

Audit Techniques

Review the current and prior 2 years to obtain an average gross receipts to determine if IRC section 263A applies. If it does apply, request the adjusting entries and work papers used to calculate the adjustment. Ensure that the taxpayer has accounted for all includible costs and has applied an appropriate absorption ratio to these costs.

Chapter 6

EXPENSES

INTRODUCTION

The team examined all expense items. The following is a brief description of each expense and a discussion of the applicable issues.

COMPENSATION OF OFFICERS

Most retail liquor stores are closely held corporations and generally the officers are also the majority shareholders. The officers/shareholders are generally involved either directly or indirectly in the operations of the liquor store. Therefore, they are entitled to reasonable compensation.

The team did not identify any significant issues in this expense.

SALARIES AND WAGES

Most retail liquor stores are open at least 6 days a week. Due to the long hours of operation most retail liquor stores have full and part time employees. Therefore, the liquor store would be entitled to deduct reasonable compensation.

The team did not identify any significant issues in this expense.

REPAIRS

Generally, retail liquor stores own or rent such assets as cash registers, refrigeration units, buildings, etc. that are used in the operation of the business. The taxpayer is allowed to deduct the cost of incidental repairs that neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition. Therefore, most repairs of these assets are ordinary and necessary expenses.

With most business tax returns there exists the potential for the taxpayer to expense an item that should be capitalized and depreciated. Generally, repairs in the nature of replacements should be capitalized and depreciated to the extent that they slow deterioration and appreciably prolong the life of the property. Review the invoices for large repair expenses to determine if properly handled.

The team made several adjustments to this expense.

BAD DEBTS

Retail liquor stores are cash intensive businesses. Generally, there are few sales on account. Therefore, the retail liquor store does not normally have bad debts. Any significant bad debt expense deduction warrants further investigation.

The team did not identify any significant issues in this expense.

RENTS

Some retail liquor stores lease or rent the building from which they operate out. The taxpayer is allowed to deduct reasonable rent expense.

Rents in Excess of Fair Rental Value

Typically, the shareholder owns the land and building used by the corporation. Therefore, rent is paid by the corporation to the shareholder. Since this is a related party transaction the corporation paying rent in excess of fair rental value is a potential issue.

The corporation benefits by paying out excess funds as deductible rents as opposed to a nondeductible dividend distribution. The shareholder also benefits on his or her personal tax return in that the income can be reduced by rental expenses (Schedule E).

Rents determined to be paid in excess of fair rental value are disallowed on the corporate tax return and generally constitute constructive dividends on the shareholder's tax return (provided the corporation has adequate earnings and profits).

See Chapter 8, Issue 4.

Passive Income Generated on Shareholder Return Used to Offset Passive Losses

The shareholder may generate passive income (gross rents less allowable expenses) from renting to the shareholder's controlled corporation. This passive income is then used to offset otherwise nondeductible passive losses. Because of the obvious control the shareholder has in determining the rent paid by the corporation, Treas. Reg. section 1.469-2(f)(6) recharacterizes this income as nonpassive. Therefore, it cannot offset nonpassive losses.

See Chapter 8, Issue 5.

Rental Losses Generated on Shareholder's Return Used to Offset Active Income

The shareholder also may generate rental losses (gross rents less allowable expenses) by renting to their controlled corporation. This rental loss is then used to offset active income up to $25,000 as allowed by IRC section 469(i).

The IRC section 469(i) offset is only allowed to offset active income if the taxpayer actively participates in the management of the property. In some cases where the shareholder rents property to his or her closely held corporation, the corporation is responsible for all capital and repair decisions. Therefore, the shareholder may not meet the active participation rules and would not be allowed to offset active income with any of the rental loss.

For more information refer to the Market Segment Specialization Program Audit Techniques Guide on Passive Activities Losses (Course No. 3149-115).

TAXES

The following taxes may be paid by a retail liquor store: payroll taxes (FICA, FUTA, state unemployment), corporate state taxes, state sales taxes, state excise taxes, local property taxes, and Federal income taxes.

The team did not identify any significant issues in this expense.

INTEREST

Assets purchased by a retail liquor store (inventory, refrigeration units, liquor license, etc.) generally require a substantial amount of money. It is usually necessary for the taxpayer to borrow at least a portion of the money and pay interest on the borrowed money. The reasonable interest paid on the business related loans is an allowable deduction.

Any money borrowed from a related party (shareholder, shareholder's relative, related corporation, etc.) should be scrutinized. There is the potential that the taxpayer could pay or receive interest in excess of a reasonable interest rate and avoid taxes by manipulating income and expenses.

The team did not identify any significant issues in this expense.

ADVERTISING

Many products a retail liquor store carries are nationally advertised by the manufacturers, such as Budweiser, Jack Daniels, etc. However it is still common for retail liquor stores to advertise locally. The retail liquor store may produce flyers or advertise with the local media such as newspapers, radio, and television. Advertising expenses should be reasonable in amount, have a reasonable relationship to the business, and be documented to be deductible.

The team did not identify any significant issues in this expense.

DEPRECIATION

Generally, retail liquor stores own various assets and are allowed to depreciate these assets. Typical assets that may be owned and used in the retail liquor business are: refrigeration units, counters, shelves, cash registers, and buildings.

Incorrect Life Used on the Depreciation of Leasehold Improvements

In many cases the retail liquor store leases the building. The lessee is responsible for leasehold improvements in many lease agreements. A potential issue exists if the retail liquor store is depreciating the leasehold improvements over the life of the lease as opposed to the life of the asset. Generally, leasehold improvements are considered improvements to real property. Therefore, use the asset life of commercial real property to calculate the depreciation expense.

Under the Modified Accelerated Cost Recovery System (MACRS) the cost of leasehold improvements made to real property are required to be depreciated without regard to the lease term (IRC section 168(i)(8)). For example, leasehold improvements made to commercial real property must be depreciated over 31.5 years.

Amortization of Liquor License

Retail liquor stores are required by law to obtain a liquor license before it can sell liquor. IRC section 197 allows amortization of intangibles, including liquor licenses, ratable over a 15 year period if purchased after August 10, 1993. Liquor licenses purchased before August 10, 1993, are treated as an intangible asset and are not amortizable. Some taxpayers may try to obtain amortization deductions on liquor licenses purchased before August 10, 1993, by transferring the liquor license and other assets to a related party. This transaction is not allowable.

See Chapter 8, Issue 6.

Personal Use of Corporate Auto

Generally, the operation of a retail liquor store will not require substantial use of an automobile, unless delivery services are offered. In Massachusetts, a liquor store cannot use an automobile to pick up or deliver alcohol unless it has a license that allows for the transportation of alcohol. An automobile on the corporate books of a retail liquor store business may have a significant amount of personal use and should be scrutinized.

An automobile is "listed property" and if used less than 50 percent for business purposes, the taxpayer must use the alternative MACRS method. Under this method an automobile will be depreciated using the straight line method over 12 years.

Some taxpayers incorrectly reduce the cost basis of the automobile by the personal use percentage instead of reducing the current depreciation amount by the personal use percentage. For example, if the corporation purchases an auto for $30,000 the allowable depreciation should be computed as follows.

<u>Step 1</u>

Depreciation Base		MACRS %		Depreciation
$30,000	x	20%	=	$6,000

<u>Step 2</u>

Since the depreciation calculated exceeds the maximum allowable for luxury autos one more calculation must still be made to apply the business use percentage. The allowable depreciation deduction is:

Luxury Auto Limitation Section 280F		Business Use		
$2,600	X	75%	=	$1,950

If you disallow auto expense due to personal use by the shareholder you would generally have a constructive dividend issue on the shareholder's tax return.

Depreciation on Assets Transferred from a Related Party (Anti-Churning Rules)

With any small business there is the potential that the taxpayer may try to benefit from the accelerated depreciation methods of MACRS. For example, if a taxpayer was in business before MACRS and/or ACRS they could transfer the assets of his or her business to a related corporation (the taxpayer must have at least 10 percent ownership). If they fail to apply the anti-churning rules, the taxpayer could begin depreciating the assets using the accelerated methods under MACRS. IRC section 168(f)(5) excludes property obtained from related parties from using the accelerated methods under MACRS. The taxpayer must continue to use the previous methods of depreciation.

PENSIONS AND PROFIT SHARING PLANS

Some retail liquor stores have a pension or profit-sharing plan set up for their employees. To examine for compliance with various pension and employee benefit rules, refer the case to an Employee Plans agent in your district. The following are some of the potential issues that should be referred to an Employee Plans agent.

Prohibited Transactions

With a closely held corporation there exists the potential for "prohibited transactions" between the corporation and the pension plan. If a disqualified person borrows monies from the pension plan, this would be a prohibited transaction. The disqualified person is liable for an excise tax equal to 5 percent of the prohibited transaction amount. In addition, a 100 percent penalty will be assessed if the prohibited transaction is not corrected within the tax period.

See Chapter 7, Mortgages and Notes Payable, and Chapter 8, Issue 13.

Pension Contributions

The taxpayer is allowed a deduction for contributions to a pension plan within certain limitations established under IRC section 404.

A contribution is deemed made on the last day of the tax year if it is paid by the due date (including extensions) of the taxpayer's tax return as stated in IRC section 404(a)(6).

A potential issue exists when the taxpayer prepares the tax return based on an expected contribution to the pension plan and fails to make a timely contribution. If the taxpayer does not file an amended return, the expense is disallowed.

EMPLOYEE BENEFIT PLANS

Generally, the only employee benefit program offered by retail liquor stores is health insurance for full-time employees and their families.

S-Corporation's Payments of a Shareholder's Health Insurance

If the taxpayer is an S-Corporation and pays the health insurance premiums for a 2 percent or greater shareholder the premiums paid by the S-Corporation must be included in the officer's/shareholder's wages as a fringe benefit. The shareholder is entitled to the self-employed health insurance deduction.

See Chapter 8, Issue 7.

OTHER DEDUCTIONS

A retail liquor store has numerous expenses under other deductions. The following are the more common expenses found during our examinations.

Automobile Expense

Some retail liquor stores deduct expenses relating to automobiles used in their business.

Business Versus Personal Use of Automobile

Generally, the operation of a retail liquor store does not require substantial use of an automobile. Making deposits and picking up supplies are usually the only business related uses of an automobile. In Massachusetts, a taxpayer cannot pick up or deliver alcohol unless the taxpayer has a license that allows for the transportation of alcohol.

Any automobile expenses that are determined to be personal expenses of the shareholder should be disallowed from the corporate tax return. A constructive dividend adjustment is also warranted using the annual lease value table. All other expenses incurred, in relation to the automobile, should be adjusted.

See Chapter 8, Issue 8.

Insurance Expense

Most retail liquor stores have insurance coverage for liability, workmen's compensation, life, and auto insurance, etc. Scrutinize any insurance expenses that may be personal expenses of the shareholder such as life insurance and auto insurance.

Any insurance expense that is disallowed as a personal expense of the shareholder should be charged to the shareholder as a constructive dividend if the corporation has adequate earnings and profits. There is no dividend distribution for the personal portion of auto insurance expense if the lease value method is used.

The team made several adjustments to this expense.

Management Fees

Many retail liquor stores expensed management fees under other deductions. These fees are normally charged by a related corporation for services such as payroll and management. These services are often performed by the shareholder(s) of these stores.

Payments to a Related Party

In one case a taxpayer, who owned two retail liquor stores, set up a management company. The management company charged both retail liquor stores fees for consulting services. The management company then paid the shareholder and other employees as subcontractors. The management company did not withhold any payroll taxes. Payroll taxes were properly assessed against the management company.

See Chapter 8, Issue 9.

Casual and Subcontractor Labor

Many retail liquor stores deduct payments for casual and sub-contractor labor.

Payments to Employees

With any taxpayer there is the potential that they will try to avoid paying payroll taxes by paying employees as subcontractors. In addition, the taxpayer may not issue Forms 1099-Misc. This could enable the individuals to avoid reporting the income.

Cash Payments to Individuals

A retail liquor store is a cash intensive business. Therefore, it is possible for the taxpayer to pay some employees with cash and not issue Forms 1099-Misc. The taxpayer may or may not deduct these payments.

NET OPERATING LOSS DEDUCTION

IRC Section 382 Limitations

A taxpayer purchased a retail liquor store with a net operating loss carryover. The taxpayer failed to calculate the limitations under IRC section 382 in determining its current net operating loss deduction.

See Chapter 8, Issue 10.

Chapter 7

BALANCE SHEET EXAMINATIONS

INTRODUCTION

Generally, examinations are conducted on income and expense accounts. In doing so, potential issues on the balance sheet may be overlooked. The following is a brief description and composition of the accounts encountered in the examination of the retail liquor stores. In addition, specific issues identified during the examinations are addressed. References are made to other areas of the audit techniques guide to supplement the information provided.

ASSETS

Cash

The cash account consists of the reconciled year end bank account and petty cash balances. Generally, the retail liquor store will have two to three bank accounts: general checking, payroll, and lottery accounts. Although the State of Massachusetts requires the store to maintain a separate bank account for lottery transactions, some stores use one bank account for all income. Some liquor stores include the cash maintained in the cash register in this account, which usually stays the same throughout the year.

Withdrawals of Corporate Funds by the Shareholder

While spinning the canceled checks of a closely-held liquor store, it was noted that there were no checks to the shareholder even though the shareholder received a salary and rental income. When questioned, the shareholder stated that he took cash from the register as needed. There were no records maintained for amounts withdrawn. However, most of the cash was deposited in the shareholder's personal account for the payment of personal expenses. Through a bank deposit analysis and personal living statement, the amount withdrawn was determined. Further analysis revealed that the corporation was making payments for some of the shareholder's personal expenses. It was determined that the shareholder received distributions from the corporation for the amounts withdrawn in excess of his salary and rental income reported.

Accounts and Notes Receivable

Accounts and notes receivable generally consist of amounts due from customers, affiliates, employees, etc. Some taxpayers include shareholder or officer loans in this account. Credit is usually given to corporate clients, caterers, and customers who frequent the store. Sales and loans to affiliate corporations are also included in this account. Most of the smaller retail liquor stores do not have any accounts receivable.

Shifting of Income

While examining the accounts receivable, of a liquor store, the following entry was found:

Purchases	$25,000.00		
		Accounts Receivable	$25,000.00

The credit to accounts receivable reduced a receivable due from a related entity.

Through further analysis, it was determined that the entry was made using arbitrary amounts with no documentation. In addition, the related entity had a net operating loss and the liquor store had a net profit for the year. Therefore, it was determined that the liquor store had shifted income to the related entity to avoid taxes. IRC section 482 was applied, disallowing the adjusting entry on both the liquor store and the related entity.

Loans to Affiliate Corporations

The records of a retail liquor store revealed loans made to a related corporation owned by the same shareholder. The balance of the account at the beginning of the year was $45,000 and $100,000 at the end of the year. A withdrawal of $55,000 was made during the tax year. Examination of this account revealed that there was no business purpose for the advances. In addition, the amounts advanced were determined not to be a bona fide debt. Based on these facts, the $55,000 is determined to be a dividend as illustrated in Hudlow, WC T.C. Memo 1971-218.

See Chapter 8, Issue 11, for the factors utilized in determining whether a bona fide loan exists.

As to the balance of the account, after the dividend distribution, interest was imputed in accordance with IRC section 7872.

See Chapter 8, Issue 12.

Inventories

To clearly reflect income, inventories at the beginning and end of each taxable year are required in every case in which the sale of merchandise is an income producing factor. All retail liquor stores are required to maintain inventories.

No Inventory Reflected in Cost of Goods Sold

During the examinations of Forms 1120A, it was determined that inventory was not reflected in the cost of goods sold section in many of the returns. When inventory changes are not considered in the calculation of cost of goods sold, cost of goods sold will likely be misstated.

See Chapter 5 and Chapter 8, Issue 3.

Retail Inventory Method Incorrect

During the examination of a retail liquor store, a markdown reserve account was found. The taxpayer stated that the inventory had been valued using the retail inventory method. Treas. Reg. section 1.471-8 requires specific records be kept on markdowns taken on the ending inventory. The taxpayer did not have specific markdown records. In addition, the computations used by the taxpayer to arrive at the ending inventory value were incorrect. As a result, cost of goods sold was adjusted to reflect ending inventory at cost and IRC section 481(a) was applied since this is a change in accounting method.

Other Assets

Other assets usually consists of prepaid expenses. Other accounts previously discussed may be classified in this account. An account unique to the liquor industry is wine futures.

Wine Futures

Some retail liquor stores purchase wine futures. These are purchases of wine prior to their release date. These futures are used as hedges against price increases. The wine purchased through futures contracts are prepaid purchases and are not includible in inventory until received by the store. This could be several years after the date of purchase.

Due to the recent promulgation of regulations under IRC sections 446 and 1221 concerning the tax treatment of hedging transactions, if the taxpayer states that they are using wine futures as a hedge against price fluctuations, it will be necessary for the agent to make a referral to the financial products group.

See Chapter 5 for more information.

Loans to Shareholder

This account consists of amounts withdrawn by the shareholder(s). Loans to shareholder(s) may also be recorded as accounts/notes receivable or other assets. This account is quite common for retail liquor stores, especially if closely held. See Rev. Rul. 83-93, 1983-2 C.B. 40,41, for a list of factors which have been identified as aids in determining whether a loan is legitimate.

Loans to Shareholder Reclassified to Dividends

The balance sheet of a retail liquor store reflects a loan to shareholder account with a beginning balance of zero and ending balance of $32,000

The $32,000 withdrawal was made payable to the shareholder. The taxpayer stated that there were no loan agreements, no interest paid, and no repayments made to the loan. The $32,000 withdrawal was determined to be a distribution in accordance with IRC section 301(c).

See Chapter 8, Issues 11 and 12.

Other Investments

Investments usually include stocks, bonds, and real estate.

The team did not identify any significant issues in this account.

Fixed Depreciable Assets

An analysis of this account can be helpful in identifying asset acquisitions and dispositions. Assets which can be found include the building, coolers, and cash registers. Typically, the shareholder owns the building and rents the space to the corporation. Some liquor stores will have automobiles on the books.

Personal Use of Corporate Automobile

Most adjustments in this area consisted of the undocumented business use of the corporate automobile.

See Chapter 8, Issue 8.

Capitalization of Expensed Items

Adjustments were made to various items which the taxpayer expensed instead of capitalizing and depreciating them.

Intangible Assets

Intangible assets for all liquor stores will include the store's liquor license. Other potential intangibles include goodwill, trademarks, franchises, etc.

Improper Amortization of Liquor License

Retail liquor stores are required by law to obtain a liquor license before it can sell liquor. A liquor license can cost a substantial amount of money. IRC section 197 allows amortization of intangibles, including liquor licenses, ratable over a 15-year period if purchased after August 10, 1993. Liquor licenses purchased before August 10, 1993, are treated as an intangible asset similar to goodwill and are not amortizable. Some taxpayers may try to obtain amortization deductions on liquor licenses purchased before August 10, 1993, by transferring the liquor license and other assets to a related party. This transaction is not allowable.

LIABILITIES

Accounts Payable

Accounts payable for the retail liquor store consists of the amounts owed to the liquor distributors.

The team did not identify any significant issues in this account.

Mortgages and Notes Payable

Mortgages and notes payable for a retail liquor store consists of loans from banks for the purchase of real estate, equipment, automobiles, or operating funds. Loans from the shareholder could also be recorded in this account.

Loans From the Corporate Pension Plan

The examination of the notes payable account of a retail liquor store revealed a loan from the pension plan to the corporation for the payment of debts. The loan from the pension plan to the corporation is a prohibited transaction subject to the 5 percent excise tax imposed by IRC section 4975.

It should be noted that there was no deduction for the contribution to the pension plan on the return and Form 5500-C/R stated that there were no prohibited transactions. This issue was identified by analyzing the notes payable account.

See Chapter 8, Issue 13.

Other Liabilities

Generally, other liabilities consists of the year end accruals for such items as salaries and payroll taxes. In addition, for a retail liquor store, wine futures may be recorded in this account.

Wine Futures

Wine futures are offered to liquor store customers. The store receives payment for the wine prior to delivery of the goods. If the advance payment from the customer is refundable it is a liability. The general rule of law is if the advanced payment is not refundable it is includible in income in the year of receipt under IRC section 451 unless it may be excluded under Rev. Proc. 71-21 or some other section of the Code.

See Chapter 4 for more information.

Loans from Shareholder

This account consists of amounts loaned to the corporation by the shareholder.

Imputed Interest on Loans from Shareholder

The balance sheet of a retail liquor store reflected a loan from the shareholder. The examination revealed that the loan was a bona fide debt but no interest had paid on the loan. Therefore, interest was imputed in accordance with IRC section 7872.

See Chapter 8, Issue 12.

Capital Stock

This account consists of the amounts paid by the shareholders of the retail liquor store for common stock.

The team did not identify any significant issues in this account.

Paid in Capital

This account usually includes amounts paid in excess of par for the purchase of the common stock. Additional contributions to capital by the shareholder should be reflected in this account.

The team did not identify any significant issues in this account.

Retained Earnings

This account reflects the accumulation of income and losses incurred during its incorporation. If the retained earnings are in excess of $250,000, a potential accumulated earnings tax may be applicable.

The team did not identify any significant issues in this account.

Treasury Stock

This account reflects amounts paid for stock redeemed by the shareholder back to the corporation.

The team did not identify any significant issues in this account. One issue that can occur in a redemption of stock is whether the redemption qualifies for capital gain treatment under IRC sections 302(a) and (b). If not, the redemption will be treated as a dividend under IRC section 302(d). In addition, the corporation may have taken deductions with respect to the redemption. Except for interest, those deductions would not be allowable by reason of the application of IRC section 162(k).

SCHEDULE M-1

Schedule M-1 is a reconciliation of income recorded on the books to income reported on the tax return. Adjustments on the Schedule M-1 should be reviewed to determine whether they are proper. In addition, determine whether there are items that should be reflected on the Schedule M-1 and are not. For example, penalties and the disallowed portion of meals and entertainment.

Penalties

Schedule M-1 of the retail liquor store did not reflect penalties although the failure to pay penalty was assessed on the late payment of payroll taxes. Examination of the tax account revealed that the penalties were deducted.

SCHEDULE M-2

Schedule M-2 is a reconciliation of retained earnings. For Form 1120S, the Schedule M-2 is a reconciliation of the accumulated adjustments account, other adjustments account, and the shareholders undistributed taxable income previously taxed.

Corporate Distribution

The shareholder of an S-Corporation, was withdrawing amounts as distributions in excess of the profits of the S-Corporation. The shareholder's return revealed that these withdrawals were treated as non-taxable distributions. The portion of the distribution in excess of the S-Corporation income was reclassified as a reduction to basis and a capital gain from the sale or exchange of property.

See Chapter 8, Issue 14.

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Chapter 8

ISSUE WRITEUPS

INTRODUCTION

This section of the guide presents significant issues that were encountered during the audits. It is written with the attributes of an unagreed report except for the taxpayer's position. Remember that no two taxpayers are exactly alike and these writeups are just examples on how the issues can be developed.

ISSUE 1 -- BOTTLE REDEMPTION INCOME

Facts

The taxpayer is a retail liquor store in the State of Massachusetts. The State of Massachusetts requires retail liquor stores to collect a 5 cent deposit on many bottles and cans sold. When the customer brings back the bottles or cans, the store returns the deposit to the customer. The store then redeems these bottles or cans with the suppliers or local redemption companies.

Retail liquor stores receive an additional 2.25 cent (7.25 cent in total) for each bottle and can redeemed to help compensate the retailer for the additional time and inconvenience associated with the process.

The taxpayer reported its sales net of pay outs to customers for bottle and can returns. The taxpayer did not report the income received from a local redemption company for redeeming these bottles and cans.

Law

IRC section 61 states that "gross income means all income from whatever source derived * * *."

Conclusion

The taxpayer is required to report income received from the bottle redemption company. If the taxpayer had not netted its gross receipts with bottle deposits paid out to customers the taxpayer would only be required to report 2.25 cent for each bottle or can redeemed (7.25 cent received from bottle redemption company minus 5 cent paid to customers for each bottle and can). However, since the taxpayer did net its gross receipts with bottle or can deposits paid back to customers the taxpayer is required to report the total amount of the checks received from the bottle redemption company.

ISSUE 2 -- LOTTERY INCOME

Facts

The taxpayer is a retail liquor store. The store filed a Form 1120 with a year end of September 30. The taxpayer stated that since it does not file on the calendar year end, the Form 1099 received from the Lottery Commission could not be used to determine lottery income. The taxpayer reported all income deposited into the lottery account as income and the withdrawals from the account as lottery expenses. The agent contacted the Lottery Commission to verify the income reported by the taxpayer. The Lottery Commission provided the agent with a detailed list of commissions earned and bonuses paid to the taxpayer for the period. This information indicated that the taxpayer had understated its lottery income.

Law

IRC section 61 states that except as otherwise provided, "gross income means all income from whatever source derived."

Conclusion

Based on third party contacts, it was determined that the taxpayer underreported its lottery income.

ISSUE 3 -- INVENTORY

Facts

The taxpayer is a small retail liquor store that filed a Form 1120-A. A deduction was taken on the return for cost of goods sold. Examination of this account revealed that the account consisted of purchases only with no accounting for inventory even though inventory was reflected on the balance sheet.

Law

IRC section 446(a) provides that taxable income is to be computed under the method of accounting regularly used by the taxpayer to compute book income. However, if the method does not clearly reflect income, the Commissioner has the authority under IRC section 446(b) to change to a method which does clearly reflect income. Treas. Reg. section 1.446-1(c) describes various permissible methods 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 for sales and purchases. The fact that year end inventory values are immaterial does not constitute an exception to the regulation. In **Wilkinson-Beane, Inc**., 70-1 U.S.T.C. 9173 the court rejected the argument that the ending inventories were immaterial and found that the purchases were significant in relation to the reported revenues.

Conclusion

A determination was made that the inventory was material and an adjustment was made to account for inventory. Adjustments involving inventories usually involve a change in accounting method. Changes in accounting method are made through two adjustments. The first adjustment made pursuant to IRC section 446(b) requires that taxable income be recorded in a manner that clearly reflects income. Therefore, the IRC section 446(b) adjustment is the change due to the reflection of beginning and ending inventories and the requirement that the accrual method be used. The second adjustment made pursuant to IRC section 481(a) disallows prior year amounts duplicated due to the adjustment to inventory. The IRC section 446(b) adjustment is always taken into income in its entirety in the year of change. The IRC section 481(a) adjustment is taken into income pursuant to Rev. Proc. 92-20, 1992-1, C.B. 685.

ISSUE 4 -- FAIR RENTAL VALUE

Facts

The taxpayer is a retail liquor store. The sole shareholder owns the building out of which the business operates. Therefore, the taxpayer is paying the sole shareholder rent. Based on the lease agreement, the taxpayer is responsible for leasehold improvements, repairs, etc.

Law

IRC section 162(a)(3) allows a deduction for "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

Although it is not directly stated in IRC section 162(a)(3), it is implied and the courts have held that only reasonable rents are an allowable deduction.

Reasonable rents have to be determined based on each case's facts and circumstances.

Amounts that are paid in excess of reasonable rents are disallowed from the corporate tax returns and would represent constructive dividends on the shareholder's tax return (provided there are adequate earnings and profits).

Conclusion

Due to the control that a sole shareholder has over the corporation, monies paid by the corporation to the sole shareholder must be evaluated based on the facts and circumstances. Based on the facts it was determined that the taxpayer deducted rents, paid to the sole shareholder, in excess of reasonable rents.

The taxpayer will be allowed a deduction for the reasonable portion of the rental payments, made to the sole shareholder, as allowed under IRC section 162(a)(3). Amounts paid in excess of the fair rental value are dividend distributions to the shareholder to the extent of earnings and profits.

ISSUE 5 -- SELF RENTALS WITH NET INCOME

Facts

The taxpayer, a sole shareholder of an S-Corporation, receives rent from the corporation. The corporation uses the property in a trade or business in which the taxpayer materially participates. An inspection of the Schedule E filed by the taxpayer indicated that the taxpayer had net income from this activity. The taxpayer classified this income as passive income from a rental activity and used it to offset passive losses that the taxpayer incurred from other activities.

Law

IRC section 469(c) defines passive activities as any activity that involves the conduct of any trade or business and in which the taxpayer does not materially participate. Passive activities include any rental activity.

IRC section 469(l)(3)(a) allows the Secretary to prescribe regulations requiring net income from a limited partnership or other passive activity to be treated as not from a passive activity.

Treas. Reg. section 1.469-2(f)(6) states that net income from property is treated as not from a passive activity if the property is rented for use in a trade or business activity in which the taxpayer materially participates (within the meaning of Treas. Reg. section 1.469-5T) for the taxable year. This section applies to net income only; any net losses are treated as losses from a passive rental activity.

Conclusion

Since it is determined that the taxpayer was renting property to an S-Corporation in which the taxpayer materially participated, the net income derived from this property will be treated as nonpassive income as required by Treas. Reg. section 1.469-2(f)(6) and will not be allowed as an offset against passive activity losses from other sources.

Exceptions

1. This rule does not apply to any rental agreement subject to a binding written contract in effect as of February 19, 1988.

2. This rule does not apply to self-rented property to C-Corporations other than closely held C-Corporations.

3. This rule does not apply to self-rented property to closely held C-Corporations for tax years ending prior to May 11, 1992. For the 1992 tax year, the taxpayer has the option to treat the income as either passive or nonpassive, depending on whether the taxpayer used the temporary Treasury Regulations under section 1.469-4T (generally effective for tax years 1989-1991) or the rules under final Treas. Reg. section 1.469-4T for the 1992 taxable year.

ISSUE 6 -- AMORTIZATION OF LIQUOR LICENSES

Facts

A retail liquor store was purchased in 1986. A liquor license was one of the assets purchased. In the original purchase and sale agreement there was no value assigned to the liquor license. The tax return showed a $20,000 intangible asset on the balance sheet. The accountant stated that this was the liquor license. In the year under exam (1992), the intangible was being amortized over 5 years.

Law

Generally, there is no depreciation or amortization expense on intangible assets with an undeterminable life. Specifically, Rev. Rul. 70-248 denies a deduction for depreciation on any license, other than a temporary license. The life of the license is created by the annual renewal of the license and cannot be estimated with any degree of certainty. Amount paid as consideration for the license is a capital investment that must be carried on the books as a capital asset. IRC section 197 allows an amortization deduction for the capitalized costs of certain intangible property over a 15-year straight-line life. Intangible property included within the amortization allowance is any lease, permit or other right granted by a governmental unit (IRC section 197(d)(1)(i)). The Conference report for the creation of IRC section 197 specifically cites a liquor license as a covered intangible. This provision applies to property acquired after the date of enactment, August 10, 1993, and under certain conditions, a taxpayer may elect to apply the section to all property acquired after July 25, 1991. (See Temp. Treas. Reg. section 1.197-1T.)

Conclusion

In this instance the taxpayer purchased (acquired) the intangible asset in 1986 and started amortizing it in 1991. The taxpayer started amortizing the liquor license due to the law change, however, it was not applicable because the asset was purchased before July 25, 1991.

ISSUE 7 -- S-CORPORATION PAYMENTS OF HEALTH INSURANCE

Facts

The taxpayer is a retail liquor store who elected to be treated as an S-Corporation. There are two shareholders each holding 50 percent of the outstanding stock of the S-Corporation. During the period under audit, the taxpayer paid all the health insurance premiums for its two shareholders.

Law

IRC section 1372 states in part that, partnership rules apply for fringe benefit purposes. For purposes of applying these provisions the S-Corporation shall be treated as a partnership and any 2 percent shareholder of the S-Corporation shall be treated as a partner. A 2 percent shareholder is defined as any person who owns (or is considered as owning within the meaning of IRC section 318) on any day during the taxable year of the S-Corporation more than 2 percent of the outstanding stock of such corporation or stock possessing more than 2 percent of the total combined voting power of all stock of such corporation.

Fringe Benefits -- IRC section 1372 neither defines that term nor identifies the specific fringe benefits to which it applies. The legislative history, however, indicates that IRC section 1372 was intended to govern the following statutory fringe benefits: (1) The $50,000 income exclusion for employer-provided group term life insurance under IRC section 79(a); (2) The $5,000 exclusion for employer provided death benefits provided under IRC section 101(b); (3) The IRC section 106 exclusion for employer-provided coverage under an accident or health plan; (4) The IRC section 105 exclusion for payments under employer accident and health plans for medical care, "permanent loss or loss of use of a member or function of the body;" and (5) The IRC section 119 exclusion for employee meals and lodging furnished for the convenience of their employer.

Rev. Rul. 91-26 states that for purposes of IRC section 1372 employee fringe benefits paid or furnished by an S-Corporation to or for the benefit of a 2 percent or greater shareholder employee in consideration for services rendered, are treated like partnership guaranteed payments under section 707(c) of the Internal Revenue Code.

Conclusion

The taxpayer failed to include as income, of the shareholders, amounts paid on the shareholder's behalf for employer provided accident and health plan. These amounts will be included in the shareholder's income under IRC section 1372 and Rev. Rul. 91-26.

In applying these adjustments, IRC section 1372 provides that accident and health insurance premiums paid on behalf of a 2 percent shareholder/employee as consideration for services rendered are treated like guaranteed payments under IRC section 707(c). Therefore, the premiums are deductible by the corporation under IRC section 162 (subject to capitalization rules of IRC section 263), and are includible in the recipient shareholder/employee's gross income under IRC section 61. The premiums are not excludable from the recipient shareholder/employee's gross income under IRC section 106; however, provided all the requirements of section 162(l) of the Code are met, the shareholder-employee may deduct the cost of the premium to the extent provided by IRC section 162(l) (self employed health insurance deduction).

ISSUE 8 -- CAR AND TRUCK EXPENSES

Facts

The taxpayer, a liquor store, maintains and deducts expenses incurred in the operation of a motor vehicle held on the corporation's books. The taxpayer stated that the vehicle was used 100 percent for business purposes. No allowances were made for personal use by the shareholder or employees. The taxpayer does not hold a license required by the State for the transportation of alcoholic beverages.

Law

IRC section 162(a) states that a deduction is allowed for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

IRC section 274(d) states that substantiation is required or no deduction or credit shall be allowed under IRC section 162 or 212 for traveling expenses, unless the taxpayer substantiates the expense by adequate records or by sufficient evidence to corroborate the taxpayer's own statements. Such records or evidence must substantiate: (a) the amount of the expense; (b) the time and place of the travel; (c) the business purpose for the expense; and (d) the business relationship to the taxpayer of any persons who used the car or truck.

Conclusion

Since the taxpayer could not provide any substantiation for the expenses, the amounts deducted as depreciation, insurance, and operational cost are being disallowed under IRC section 162 as not being ordinary and necessary and IRC section 274(d) for lack of substantiation.

ISSUE 9 -- MANAGEMENT FEES TO CORPORATE OFFICERS ARE WAGES

Facts

An individual (Mr. Smith) is the president and sole shareholder of two corporations. Corporation One operates a retail liquor store. Corporation Two is a management company. Corporation Two provides accounting services to corporation One for a fee. Corporation One deducts the amounts it pays for these accounting services as ordinary and necessary business expenses. Mr. Smith, as president of Corporation Two, performs services for Corporation Two as an officer. Corporation Two pays Mr. Smith management fees for his services and the amount of the fees is considered to be reasonable for the services performed. Corporation Two treats Mr. Smith as an independent contractor and reports the management fees on Form 1099 and deducts the expense.

Law

Section 3121(d) of the Internal Revenue Code, pertaining to the Federal Insurance Contributions Act (FICA), provides the statutory definition of the term "employee." IRC section 3121(d)(1) provides that the term shall include any officer of a corporation. Section 3306(i) of the Code, pertaining to the Federal Unemployment Tax Act (FUTA), defines the term "employee" as having the meaning assigned by section 3121(d), with certain exceptions not applicable to this situation. Section 3401(c) of the Code, pertaining to income tax withholding, includes within its definition of the term "employee," an officer of a corporation. The legislative history to a 1948 amendment of the predecessors to sections 3121(d) and 3306(i) states that:

> The section retains the provision of the existing law that an officer of a corporation is to be treated as an employee, even though he may not be regarded as such under the usual common-law rule.

H.R. Rep. No. 1319, 80th Cong. 1st sess. 6 (1948)

Conclusion

Mr. Smith, as an officer of Corporation Two, is a statutory employee of Corporation Two. The payments made from Corporation Two to Mr. Smith are wages which are subject to employment taxes under FICA and FUTA.

ISSUE 10 -- NET OPERATING LOSS DEDUCTION

Facts

During the pre-audit of a retail liquor store it was determined that the taxpayer's net operating loss deduction for the year under audit was more than 50 percent of the taxpayer's gross receipts for that year. The taxpayer stated that "the loss had been incurred prior to his purchase of the store. The taxpayer was questioned regarding the application of IRC section 382 in conjunction with IRC section 172. The taxpayer stated that these Code sections were not considered. The taxpayer provided the examiner with a copy of how the losses had been applied during the prior periods.

Law

IRC section 172(a) allows as a deduction the net operating loss carryovers. IRC section 172(b) states that the years to which the net operating loss may be carried are back to each of the 3 taxable years preceding the taxable year of such loss and over to each of the 15 taxable years following the taxable year of the loss.

IRC section 382(a) states that the amount of the taxable income of any new loss corporation for any post-change year that may be offset by pre-change losses shall not exceed the IRC section 382 limitation for such year.

The Section 382(a) limitation is computed under IRC section 382(b). This section states, except as otherwise provided in this section, the section 382 limitation for any post-change year is an amount equal to the value of the old loss corporation, multiplied by the long term tax-exempt rate. Any pre-change loss not used up in the first year shall be carried forward.

Conclusion

The taxpayers failed to apply the provisions of IRC section 382 in computing the net operating loss deduction for the year and in so doing overstated such loss for the tax periods under audit. The net operating loss deduction applying IRC section 382 limitations was recomputed as follows:

Limitation Calculation

FAIR MARKET VALUE OF OLD CORPORATION		LONG TERM TAX EXEMPT RATE		LIMITATION
$ 500,000.00	X	7.46%	=	$ 37,300.00

ISSUE 11 -- LOANS TO SHAREHOLDERS

Facts

The taxpayer is a corporation which operates as a retail liquor store. The balance sheet reflects a loan to shareholder account with a beginning balance of zero and ending balance of $32,000. The $32,000 withdrawal was made payable to the shareholder. The taxpayer stated that there were no loan agreements, no interest paid, and no repayments made on the loan.

Law

IRC section 316(a) defines the term "dividend," as any distribution of property made by a corporation to its shareholders out of its accumulated and current earnings and profits.

IRC section 301(c) defines the treatment of a distribution of property from a corporation to a shareholder. The portion of a distribution defined as a dividend under IRC section 316(a) is included in gross income. The portion of the distribution which is not a dividend is applied first against the adjusted basis of the stock, and to the extent that the distribution exceeds the adjusted basis of the stock such amount is treated as a gain from the sale or exchange of property.

Whether payments to stockholders of a closely held company are loans or constructive dividends is a question of fact to be decided according to the relevant facts and circumstances. (Williams v. Commissioner, 80-2 U.S.T.C. 9550.)

Conclusion

The taxpayer does not dispute the nature of the transaction which created the loan to stockholder account but refutes the contention that the withdrawal is a constructive dividend. The taxpayer argues that the corporate minutes and the debt instrument establish a declared intent to repay and the failure to make the repayment was attributable to a slow economy. The taxpayer further argues that the characterization of a distribution as either a dividend or a loan should be determined by the intent of the parties at the time the event took place. Finally, the taxpayer stated that the amount is a loan because the corporation would never declare or pay a dividend in adverse economic conditions.

With respect to the debt verses dividend issue, the courts have looked to a number of factors in deciding the issue. These factors are as follows:

1. The taxpayer's significant control and dominion over the corporation.

2. The corporation's dividend history.

3. The size of the withdrawals.

4. Whether or not the corporation imposed a ceiling on the amounts that might be borrowed.

5. Whether there were definite maturity dates.

6. Whether or not there were attempts to force repayment.

7. Intention or attempts to repay.

8. The shareholder's ability to liquidate the loan.

9. A large retained earnings surplus.

10. Failure to execute notes.

The taxpayer's determination that the loan is valid only addresses the factors of intent and note execution and makes no reference to the other factors stated above. Some of the applicable factors are addressed below.

The taxpayer exercised his control over the corporation's assets to benefit his own personal interests. In ***Wortham Machinery Company v. United States***, 10 Cir., 521 F. 2d 160, 164, the court stated that, "A constructive dividend is paid when a corporation confers an economic benefit on a stockholder without expectation of repayment." The taxpayer's reliance on an economic decline being the only obstacle preventing repayments is not only inconsistent but provides further evidence that the withdrawal was a dividend and not a loan. The corporation's large cash balance coupled with significant retained earnings, indicate the corporation's ability to pay a dividend. The fact this was more attributable to the corporation's prior earnings than current earnings does not change the character of the withdrawal.

The corporation has never declared or paid a dividend.

In a closely-held corporation, the factors pertaining to the limitations on the amounts borrowed and the corporation's efforts to enforce repayment would require an arms length debtor/creditor relationship to exist. (***Alterman Foods Inc***., U.S.T.C. 75-1

9151)

The fact that the shareholder provided a note with a stated interest rate and a definite maturity date are indicative of a debt transaction. However, as in ***Litton Business Systems, Inc. v. Commissioner***, 61 T.C. 367,377, acq., 1974-2 C.B.3, the goal is to determine whether there was a genuine intention to create a debt with a reasonable expectation of repayment, and whether that intention comports with economic reality. Furthermore, in ***Tyler v. Tomlinson***, 69-2 U.S.T.C. 9559, the court recognized that it "requires more than a declaration of intention to create an indebtedness and more than the existence of corporate paper encrusted with the appropriate nomenclatural captions." Following the execution of the debt instrument, there was no further acknowledgment of the shareholder's indebtedness by either the corporation or the shareholder.

Where corporate advances are made to the corporation's sole stockholder, courts look with great care to the surrounding facts and view with some suspicion, declarations of intent which have the effect of maximizing the tax benefit of the stockholder. (***Alterman Foods, Inc. v. United States***, U.S.T.C. 75-1 9151.)

The $32,00 withdrawal was determined to be a distribution in accordance with IRC section 301(c). A distribution will only be treated as a constructive dividend to the extent of available earnings and profits as computed under IRC section 312.

ISSUE 12 -- IMPUTED INTEREST

Facts

The taxpayer is a closely-held corporation which operates as a retail liquor store. The corporation is owned 100 percent by Mr. Adams. The balance sheet reflected a loan to the shareholder in the amount of $95,000 at year-end.

The taxpayer provided loan documents in which the interest rate charged was less than the applicable Federal rate. The factors as discussed in Issue 11 were used to determine whether the loan was a bona fide debt. The agent determined that the loan was a bona fide debt. Interest was imputed under IRC section 7872 to reflect an arms-length interest rate.

LAW

IRC section 7872 requires the Service to impute interest on loans bearing no interest rate or a rate which is less than the applicable Federal rate. IRC section 7872 recharacterizes a below-market loan as two transactions:

1. An arm's length transaction in which the lender makes a loan to the borrower in

exchange for a note requiring the payment of interest at the applicable Federal rate

2. A transfer of funds by the lender to the borrower ("imputed transfer").

The timing and characterization of the amount of the imputed transfer are determined in accordance with the substance of the transaction. Generally, the imputed transfer of forgone interest for demand loans is considered to take place on December 31.

Conclusion

In this case, the loan is a corporation-shareholder loan. The imputed transfer is treated as a distribution of money (characterized according to IRC section 301 or in the case of an S-Corporation, IRC section 1368). The corporation would be required to report imputed interest income deemed re-transferred by the shareholder.

For tax year 1992, the interest calculation is:

$ 95,000 x 4.98% = $4,731

The deemed interest rate for a below-market loan is determined in accordance with IRC section 7872 and the regulations thereunder and IRC section 1274. Since the principal amount was outstanding for the entire calendar year, a blended annual rate can be used. For 1992, the blended annual rate is 4.98 percent as published in Rev. Rul. 92-50, 1992-2 C.B. 205.

Accordingly, the corporation would report interest income in the amount of $4,731. The shareholder would report a distribution of $4,731.

ISSUE 13 -- PENSION PLAN PROHIBITED TRANSACTIONS

Facts

During the audit of the taxpayer's Form 1120 for the year ended December 31, 1991, it was discovered that the corporation had borrowed funds from its pension plan to pay debts. The subsequent year's return indicated that the corporation had borrowed more money. The following pension plan transactions are as follows:

Date	Pension Plan Assets	Receivables From Corporation	Percent of Total Assets
12/31/91	$400,000	$200,000	50%
12/31/92	$400,000	$325,000	81%

These transactions were determined to be prohibited. The taxpayer was informed that these transactions were considered prohibited transactions. The taxpayer provided copies of Forms 5500-C/R filed for the years in question.

Law

IRC section 4975 imposes a 5 percent excise tax on prohibited transactions. A prohibited transaction is the lending of money or other extensions of credit between a plan and a disqualified person. A disqualified person is a corporation, partnership, or trust or estate of which (or in which) 50 percent or more of the beneficial interest of such trust or estate, is owned directly or indirectly, or held by the employer of whose employees are covered by the plan.

Conclusion

The taxpayer was assessed the excise tax, for all the tax years involved, due to the prohibited transaction. The taxpayer also refunded the amounts borrowed from the pension plan as required.

ISSUE 14 -- S-CORPORATION DISTRIBUTIONS

Facts

The taxpayer is a retail liquor store filing as an S-Corporation. During the audit it was found that the taxpayer had been withdrawing amounts in excess of profits from the S-Corporation. An inspection of the shareholder's return indicated that he had treated all of the amounts distributed as nontaxable.

Law

IRC section 1368(a) states that a distribution of property made by an S-Corporation with respect to its stock shall be treated as follows where the taxpayer has no accumulated earnings and profits: (1) The distribution shall not be included in gross income to the extent that it does not exceed the adjusted basis of the stock; (2) If the amount of the distribution exceeds the adjusted basis of the stock, such excess shall be treated as a gain from the sale or exchange of property.

Conclusion

The shareholder's basis in the S-Corporation at the beginning of the year under audit was zero and the S-Corporation had net income of $25,000 for the year. Since the shareholder for the year under audit withdrew amounts in excess of the S-Corporation's net income, IRC section 1368(b)(2) applies. Therefore, the amounts withdrawn in excess of basis shall be treated as a gain from the sale or exchange of property.

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GLOSSARY

ABCC -- Alcohol Beverage Control Commission in Massachusetts.

DAILY SALES SHEETS -- A daily sheet prepared by a store to reconcile the Z totals (the final register readings for a day) to the cash in the register.

DISTRIBUTORS -- The name given to the wholesalers of liquor products in Massachusetts.

GROSS MARGIN (PROFIT) The percentage of sales that is profit.

Example: Product cost $10
Gross Margin 25%
Selling Price 10/(100%-25%) = $13.33
or 10/75% = $13.33

PRICE JOURNAL -- ***The Massachusetts Beverage Price Journal*** -- A cost book listing the wholesale prices for every liquor brand and product sold in the State of Massachusetts. These are the actual prices the liquor stores pay for their purchases.

MALT BEVERAGES -- All beer type products.

MARK-UP -- An amount added to the cost of a product to arrive at a selling price.

Example: Product cost $10
Mark-up % 25%
Selling price $10 X 25% = $2.50
$10 + $2.50 = $12.50

NET OVER/SHORT -- The amount of the cash that is either above or below net sales for the day.

PACKAGE STORE LICENSE -- A license the State of Massachusetts requires each store to obtain to sell liquor.

PIA CODES -- Principle/primary industry activity code used by the IRS.

SIC -- Standardized industry codes used by the general public.

UPC LABELS -- Universal pricing code label.