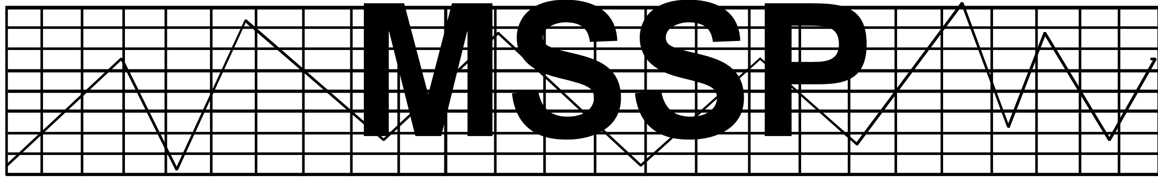

Market Segment Specialization Program

Veterinary Medicine

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

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

Department of the Treasury
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Foreword

Veterinarians are part of the health care industry. Preparation of this ATG included consideration of the Los Angeles District information package titled *Healthcare Industry*. The package was useful because medical procedures, record maintenance, terminology, and audit issues are similar.

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Chapter 1

Description of the Practice of Veterinary Medicine

History

Doctors of Veterinary Medicine are medical professionals, whose primary responsibility is protecting the health and welfare of animals and people. The first College of Veterinary Medicine in the United States was established in 1879 at Iowa State University. Before that time animals were treated by veterinarians trained in Europe or by individuals without formal education. Veterinary medicine has progressed very rapidly in the one-hundred plus years since then. Veterinarians have been at the forefront in control of diseases such as tuberculosis, brucellosis, hog cholera, and Newcastle disease of chickens.

Today veterinarians in private clinical practice are responsible for the health of approximately 52 million dogs, 55 million cats, 11.7 million birds, and more than 7 million other pet animals. They also care for more than 8 million horses, 115 million cattle, 56 million hogs, and 12 million sheep and lambs that make up our nation's $80 trillion livestock industry. In 1995, there were 27 colleges of veterinary medicine in the United States graduating approximately 2,100 new veterinarians each year.

Demographics of Veterinarians

There are, based on 1998 data from the American Veterinary Medical Association (AVMA), 75,000 veterinarians in the United States. Of those, 62,016 (83 percent) are members of the AVMA.

The 62,016 are further broken down by the following categories:

4,453	Large Animal Practice (Horse, Cattle, Sheep, Goats, Swine, etc.)
13,752	Mixed Practice (Large Animal and Pet Animal)
28,620	Small Animal Practice (Dogs, Cats, and other pets)
46,825	(76 percent of AVMA members are providing direct service to animals in a practice setting)

The remainders are in academia, research, state and federal government employment (including military), and public health and industry. It is estimated that the average veterinary practice in the United States has 2 veterinarians involved in the practice. Using that figure, there are approximately 23,413 private veterinary practices in the United States providing medical care and professional services to animals on behalf of their owners.

Education

Veterinarians require a minimum of 3 years pre-veterinary education followed by a 4-year veterinary curriculum resulting in a doctor of veterinary medicine degree. The curriculum is extensive and includes both preclinical sciences and clinical sciences involving all known species of animals as well as the public health aspects of animal care and disease.

Veterinarians are not required to complete an internship before beginning practice. However, many internship and residency programs exist and an increasing number of new graduates are taking advantage of them. Before graduate veterinarians can engage in private clinical practice, they must acquire a license issued by the state. A license is granted only to veterinarians who pass state-required examinations.

What Veterinarians Do

Veterinarians diagnose and control animal diseases, treat sick and injured animals, prevent the transmission of animal diseases to people, advise owners of proper care of pets and livestock, and ensure a safe food supply for people by maintaining the health of food producing animals.

Veterinarians examine their animal patients, vaccinate them against diseases, treat illnesses, perform radiological and laboratory examinations, act as a pharmacy, perform surgery, and advise the animal owners on ways to keep pets and livestock well nourished and healthy.

They may see their patients in a veterinary hospital or they may care for their patients on farms, ranches, feedlots, or other facilities. There are a very limited number of veterinary hospitals that are publicly supported. Veterinarians, in most cases, either own the building and equipment used to provide medical services for their patients outright, or rent it from a related entity.

Veterinarians, especially those who care for the "large" food producing animals and horses, must maintain large inventories of animal drugs and supplies to provide these services since commercial pharmacies rarely have the required quantity of biologicals and pharmaceuticals for animals. In these ways, veterinarians share the unique roles of medical service provider, pharmacist, and business owner.

Definition

The industry includes all individuals or entities in the industry engaged in the practice of veterinary medicine through ownership or management of practices, organizations, facilities, or equipment which provide medical services to animals. Practitioners' activities may be reported on Form 1040 (wages or Schedule C practice), Form 1065, Form 1120, or Form 1120S. Owners of facilities and veterinary organizations generally will report as partnerships or corporate entities. The veterinary medical practice industry includes, but is not limited to:

> Sole Practitioners
> Veterinary Clinics
> Veterinary Hospitals
> Diagnostic Imaging Services
> In-Vitro Fertilization Clinics
> Veterinary Organizations
> Regulatory Agencies
> Educational Institutions

Veterinarians by Type of Practice

Veterinarian practices can also be differentiated by the type of animals treated. This section discusses three major categories:

A. Large Animal (exclusive and predominant)
B. Small Animal
C. Mixed Animal

A. Large Animal

One of the characteristics that distinguishes a large animal veterinary practice or a mixed animal practice from a small animal veterinary practice is the fact that most large animal care is provided at the client's premises rather than at the site of the veterinary practice. However, not all large animal care is delivered in the field. Most large animal practices have some type of in-house surgery or facility for treating animals on the premises when necessary. These in-house facilities will vary in the type of equipment, etc. from the very simple (for example, a couple of stalls) to the state of the art specially constructed surgeries which have been designed to accommodate the physiology of the animal being treated.

Large animal veterinary care provided at the client's premises may alter the nature of the practice and its records in several ways. It is common for the veterinarian to treat from one to several hundred animals during one visit. To expedite service in the field, large animal veterinarians have vehicles that are equipped to transport medications, drugs, supplies, and equipment. They may conduct something as simple as pregnancy tests or vaccinations on several hundred dairy cattle during one visit or as complex as treating a particular disease outbreak on several hundred beef cattle or hogs. The nature of animal agriculture is such that the close quarters in which cattle are maintained in feedlots, or dairy or hog facilities require controlling disease immediately as a matter of preventing financial disaster to the farmer.

Because the veterinary care is delivered at the client's premises, it is common for the veterinarian not to receive payment at the time the services are rendered. A "trip sheet" or "trip ticket" will probably be prepared showing the client's name, the date the procedure was performed, the drugs dispensed or administered, the number of animals treated for each procedure or administration and the mileage charged. Upon return to his/her office, the veterinarian will give the document to a staff member who will use it to prepare an invoice. The timing of sending invoices will vary from daily to once or twice monthly. As a result, large and mixed-animal practices tend to maintain an active and ongoing accounts receivable. The particulars of whether or not the veterinarian accepts payment at the time of the service, the frequency of sending invoices, and the existence of an accounts receivable should all be specifically documented during the initial interview.

As in most retail/wholesale businesses, veterinarians may offer different fee structures to their customers. High-volume customers may be charged less for medications and drugs than the occasional customer. If this is the case, the practice will generally utilize an indicator on its client list denoting the status as a low, middle, or high volume client. The key for this coding should be obtained during the initial interview.

Another significant feature of this type of practice is the large inventory of medicines that must be maintained to respond quickly to disease outbreaks or requests for vaccination. Determine what types of inventory records are maintained and how often a physical inventory is taken.

Be aware that many large animal veterinarians often keep cattle, horses, or swine on their own farms. Determine at the initial interview how personal use items are accounted for by the veterinarian.

Large animal practices are also subject to seasonal fluctuations in the workload due to the differing demands of the animals treated. For instance, a practice devoted mainly to the treatment of cattle tends to be busiest during the spring and again during the last three months of the year. A practice specializing in the care of horses will have its busiest season during the spring. Seasonal fluctuations in business should be fully explored and documented during the initial interview and reconciled to the taxpayer's records. (See Chapter 2 for a complete discussion on selection of a taxable year.)

B. Small Animal

Small animal practices vary from large animal practices in several ways. Most of their customers come to the practice premises to be treated and payment is expected at the time the treatment or service is rendered. However, due to the ever increasing cost of treatments, more and more veterinarians are allowing payment schedules. In addition, there are now several national pet insurance companies. These companies allow the customer to select any veterinarian nationwide and then will make a payment to the veterinarian or the insured based on a schedule of allowances less a small deductible. For this reason even small animal practices may maintain an accounts receivable. How and when payment is expected should be discussed during the initial interview.

Since small animals are treated one at a time, not in herds, generally the need to maintain large inventories of drugs and supplies will also be diminished. A recent trend in small animal practices has been to combine several small animal practices under one common ownership creating a larger economic unit with which to obtain pricing discounts on purchases of drugs and supplies. These larger organizations often maintain central purchasing and inventory facilities and will maintain larger inventories as a result. Therefore, it will be necessary to determine how purchases are made and how much is kept on-hand during the initial interview.

C. Mixed Animal

Mixed animal practices will combine elements of both large and small animal practices and will require an in-depth interview to determine which elements of each are used in the practice.

Industry Terminology

Much of the terminology used is unique to the industry. However, it is similar to the terminology used in the health care industry. A glossary of terms is included in Appendix A. It is recommended that examiners familiarize themselves with the terms unique to this industry prior to the initial interview in order to facilitate the examination.

Industry Organizations

See Exhibit 1-1.

Incomes of U.S. Veterinarians

A professional journal titled *Veterinary Economics* annually conducts a statistically valid survey of veterinarians to compile information about practice revenue by type of practice, personal income by type of practice, and different expense categories as a percentage of revenue by type of practice. The survey results are published annually in the fall (September and November) with one issue devoted to the expense side and another issue devoted to the revenue side. These surveys may be a useful source of information and are found at libraries of Colleges of Veterinary Medicine. In addition, the taxpayer/veterinarian may also subscribe to this journal.

Additional information can be obtained by contacting the American Veterinary Medical Association or other professional associations listed in Exhibit 1-1.

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Exhibit 1-1
Industry Organizations

	Organization	Web site
1.	Agricultural Research Service	www.ars.usda.gov
2.	American Animal Hospital Association	www.healthypet.com
3.	American Association for Accreditation of Laboratory Animal Care (*now know as* Association for Assessment and Accreditation of Laboratory Animal Care International (AAALAC International)	www.aaalac.org
4.	American Society for the Prevention of Cruelty to Animals	www.aspca.org
5.	American Veterinary Medical Association	www.avma.org
6.	Animal and Plant Health Inspection Service	www.aphis.usda.gov
7.	Association of American Veterinary Medical Colleges	www.aavmc.org
8.	Centers for Disease Control and Prevention	www.cdc.gov
9.	Environmental Protection Agency	www.epa.gov
10.	Food and Drug Administration	www.fda.gov
11.	Food Safety and Inspection Service	www.fsis.usda.gov
12.	National Animal Health Monitoring System	www.aphis.usda.gov/vs/ceah/cahm
13.	National Institutes of Health	www.nih.gov
14.	National Research Council	www.nas.edu/nrc
15.	National Science Foundation	www.nsf.gov
16.	National Veterinary Services Laboratories	(Web site not found)
17.	North American Veterinary Technician Association	www.avma.org/navta/default.htm
18.	Technology Assessment, The Congress	www.wws.princeton.edu/~ota/
19.	Pan American Health Organization	www.paho.org
20.	U. S. Public Health Service	www.phs.os.dhhs.gov/phs/phs.html

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Chapter 2

Selection of Entity, Tax Year, and Accounting Method

Entity Overview

Veterinarians provide their services through proprietorships, partnerships, corporations, and limited liability companies (elective by either a partnership or corporation). If a veterinary medical practice is organized as a C corporation, the corporation may be subject to IRC section 441 (concerning personal service corporations (PSCs)) and IRC section 448 (concerning qualified personal service corporations (QPSCs)). These rules also apply to a limited liability company that elects to be taxed as a corporation.

A. Personal Service Corporation

Under IRC section 441, a "personal service corporation" is a C corporation whose principal activity is the performance of personal services and whose personal services are substantially performed by employee-owners.

IRC section 448 requires all C corporations to use an accrual method of accounting for the first taxable year beginning after December 31, 1986, unless one of the enumerated exceptions is satisfied. IRC section 448(b)(2) provides an exception for qualified personal service corporations. To be a QPSC, a corporation must satisfy both a function test and a stock-ownership test. See IRC section 448(d)(2), Treas. Reg. section 1.448-1T(e)(4), Treas. Reg. section 1.448-1T(e)(5).

Function Test

Substantially all (95 percent or more) of the activities of the corporation must involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. For this purpose, the performance of any activity incident to the actual performance of services in the qualifying field is considered the performance of services in that field. For example, supervising employees who perform qualifying services and performing administrative and support services incident to those activities. See IRC section 448(d)(2)(A) and Treas. Reg. section 1.448-1T(e)(4).

Stock-ownership Test

Substantially all (95 percent or more) of the corporation's stock (by value) must be owned directly (or indirectly through one or more partnerships, S corporations, or QPSCs not described in IRC section 448(a)(2) or (3)) by:

1. employees who are performing services that satisfy the function test on the corporation's behalf (for example, a physician performing medical services);
2. retired employees who had performed these services on the corporation's behalf;
3. estates of employees or retired employees who had performed these services on the corporation's behalf; or
4. other persons who acquired stock from employees or retired employees who had performed services on the corporation's behalf (but only for a 2-year period). See IRC section 448(d)(2)(B) and Treas. Reg. section 1.448-1T(e)(5).

The common parent of an affiliated group (within the meaning of IRC section 1504(a)) may elect to treat all members of that group as a single taxpayer for the purpose of testing whether the stock-ownership test has been met. See IRC section 448(d)(4)(C) and Treas. Reg. section 1.448-1T(e)(5)(vi).

Effects of Being a PSC

1. **Flat 35 Percent Corporate Tax Rate** -- unlike other C corporations which are subject to graduated income tax rates beginning at 15 percent, a PSC is taxed at a flat tax rate of 35 percent.
2. **Calendar Year Required** -- unlike other C corporations, which can adopt a fiscal tax year, a PSC is required to adopt a calendar year unless they can show a business purpose.
3. **Passive Activity Losses Limited** -- unlike many C corporations which can deduct passive losses against their active income, a PSC cannot offset passive losses against its active income. However, generally a PSC will not have passive losses because the PSC will be treated as materially participating under IRC section 469(h)(4) as a result of the activity of the majority shareholder.

B. Conversion of a PSC to a Limited Liability Company

Many PSCs might prefer to organize as a Limited Liability Company (LLC) because of the greater flexibility afforded LLCs. Presently, PSCs must pay a corporate tax at the highest corporate rate without the advantage of graduated rates. There are special classification issues for PSCs as to whether they can use the cash method of accounting or elect to use IRC section 444 fiscal year. These same classification issues could be avoided by moving into LLC status.

Converting to an LLC may be relatively easy for the single-owner PSC. In these situations, the PSC probably pays little if any corporate tax because earnings are paid out as deductible compensation to the shareholder/employee.

The most substantial asset that the PSC has is its accounts receivable and possibly a partnership interest in a lower-tier partnership. Under the cash method of accounting, a distribution out of the receivables would trigger an IRC section 336 gain on liquidation to the extent of the fair market value as reflected in the zero basis receivables. Thus, rather than liquidating immediately, the receivables could be retained in the PSC until they are collected and income is recognized on their receipt. Any cash would then be paid out in the form of compensation and the corporation could then be liquidated without any further tax (unless there is a partnership interest distributed).

Note: Costs for converting a PSC to an LLC (that is, legal fees) should be capitalized. See *Indopco, Inc.* v. *Commissioner*, 503 U.S. 79, 112 S. Ct. 1039 (1992).

Determination of a Tax Year

Determining the correct tax year to be used for reporting purposes can have a major impact on how income and expenses will be reflected, both on the practice's books and on the tax return. As previously mentioned, veterinarian practices differ in the type of animals treated which can affect when income is received versus when expenses are paid. To counter this problem, the veterinarian will have to determine the correct tax year to use.

Generally, a corporation meeting the definition of a PSC under IRC section 441 is required to utilize a calendar year accounting period for purposes of filing its tax return. However, if the corporation can establish a business purpose, they may request a different taxable year under IRC section 441(i).

There are two different methods for establishing a substantial business purpose for using a tax year other than the required calendar year. Under the first method, the partnership, S corporation, or PSC can establish a "natural business year" by meeting a mechanical test. See section 4 of Rev. Proc. 87-32, 1987-2 C.B. 396. An entity that cannot satisfy the requirements for demonstrating a natural business year under Rev. Proc. 87-32 may attempt to establish a substantial business purpose under the more general facts and circumstances test.

The mechanical test for a natural business year is one in which at least 25 percent of the taxpayer's gross receipts are received in the last 2 months of the 12-month period that the taxpayer desires to use as its tax year. The gross receipts from sales and services are calculated for the most recent 12-month period of the requested fiscal year that ends before filing the request. Gross receipts are also calculated for the last 2 months of the same period. The yearly figure is divided into the 2-month figure and must equal at least 25 percent. The same calculations are made for the two 12-month periods preceding the 12-month period used in the initial calculations as required in Rev. Proc. 87-32. A taxpayer that does not have a 47-month history of gross receipts may not establish a natural business year. If more than one fiscal year qualifies as a natural business year, the taxpayer must use the fiscal year producing the highest percentage of receipts in the last 2 months.

The facts and circumstances test could include factors that may indicate a substantial business purpose such as: seasonal business taxpayers, inability to meet the natural business year test due to unusual circumstances, or more than one natural business year. See Rev. Proc. 74-23, 1974-2 C.B. 489. Factors that are generally insufficient to establish a substantial business purpose include accounting purposes and taxpayer's convenience.

The veterinarian must demonstrate a substantial business purpose for adopting a particular fiscal year based on all of the facts and circumstances, including the tax consequences of the election. If the requested tax year creates a deferral or distortion of income or deductions, nontax factors must demonstrate compelling reasons for the requested tax year. See Rev. Rul. 87-57, 1987-2 C.B. 117.

Some of the tax consequences that will be considered in determining whether to accept a fiscal year based on a substantial business purpose are:

1. whether the tax year would defer a substantial portion of a taxpayer's income or shift a substantial portion of the taxpayer's deductions from one year to another, resulting in a substantial reduction in the taxpayer's tax liability;
2. whether the tax year would cause an income deferral or shift of deductions to any other person, such as a partner, beneficiary, or shareholder; and
3. whether the desired tax year would create a short period in which there is a substantial net operating loss.

How to Request a Change in Tax Year under Rev. Proc. 87-32 (Form 1128)

If a partnership, S corporation, or a PSC desires to change to a tax year that is its natural business year (section 4.01(1)), or an S corporation desires to change to a tax year that meets the "ownership tax year test" (section 4.01(2)), then Form 1128, Application to Adopt, Change, or Retain a Tax Year, must be filed with the IRS. Form 1128 must be filed on or before the 15th day of the second calendar month following the close of the short period for which a return is required in order to effect the change in the accounting period.

The following information should be attached to Form 1128:

1. whether the selected tax year represents a retention or a change of tax year;
2. the calculations for the mechanical test as described above; and
3. the following representation, whichever is applicable, signed by a partner, in the case of a partnership, or by an authorized corporate officer:

> "Under penalties of perjury, I represent that *(insert name of veterinarian)* is changing to a tax year that coincides with its natural business year as defined in section 4.01(1) and as verified by its satisfaction of the requirements of section 4.02(1) of Rev. Proc. 87-32."

or

> "Under penalties of perjury, I represent that, as of *(insert the first day of the tax year to which the request relates)*, shareholders holding more than one-half of the shares of the stock of *(insert name of S corporation)* have the same tax year or are concurrently changing to the tax year that *(insert name of S corporation)* is changing to per this statement."

A PSC desiring to change to a fiscal year that coincides with its natural business year may use an expeditious approval process. Form 1128 should be marked "filed under Rev. Proc. 87-32" and filed with the IRS service center where the taxpayer files its returns. There is no user's fee when requesting the change under Rev. Proc. 87-32. Taxpayers who do not meet the natural business year test may request permission to adopt a fiscal year for business purposes by filing Form 1128 with the IRS's National Office in Washington, D.C.

Selection of Proper Accounting Method

An accounting method is a set of rules used to determine when and how income and expenses are reported. The choice of accounting method includes not only the overall method of accounting used, but also the accounting treatment used for any material item.

A taxpayer chooses its accounting method when it files its first tax return. After that, if a taxpayer wants to change its accounting method, it must first get permission from the Commissioner of Internal Revenue. See "Change in Accounting Method," later.

There are three main methods of accounting which may be used by veterinarians.

A. Cash Method

The cash method of accounting is used by most sole proprietors, PSCs and partnerships with no inventories. However, if inventories are necessary in accounting for income, then the accrual method for sales and purchases is required. With the cash method, all items of income actually or constructively received during the year are included in gross income. This includes the fair market value of property and services received. Usually, expenses are deducted in the tax year in which actually paid.

B. Accrual Method

Under an accrual method of accounting, income is generally reported in the year earned, even though payment may be received in another tax year. Items are included in gross income in the tax year in which all events that fix the right to receive the income, and the amount can be determined with reasonable accuracy. Business expenses are deducted or capitalized when the liability is incurred, whether or not they are paid in the same year. For this purpose, the liability is recognized in the tax year in which both the "all events" test and the economic performance rules are met. The purpose of an accrual method of accounting is to match income and expenses in the correct year.

C. Hybrid Method

The hybrid method is the use of any combination of cash, accrual, and special methods of accounting if the combination clearly shows income and it is used consistently. However, the following restrictions apply:

1. If inventories are necessary to account for income, then the accrual method must be used for purchases and sales of inventory items. An accrual method must also be used to account for the receipts from services that are intertwined with the sales of inventory items. The cash method may generally be used for all other items of income and expenses.
2. If the cash method for reporting expenses is used, then the cash method for computing income must also be used.
3. If an accrual method for reporting expenses is used, then that accrual method must also be used for figuring income.

Use of the hybrid method of accounting in a veterinary practice could include reporting the sale of veterinary products that are not provided in connection with services on the accrual basis AND reporting the veterinary services and *de minimis* merchandise provided in connection with such services under the cash method. Treas. Reg. section 1.446-1(c)(1)(iv) recognizes that a combination of methods of accounting may be permitted in connection with a trade or business if such combination clearly reflects income and is consistently used. A hybrid method might clearly reflect income if:

1. the merchandise provided incident to services is *de minimis*;
2. the other veterinary products sold by the taxpayer are severable from the services and related *de minimis* merchandise; and
3. the taxpayer keeps its books and records in such a way that the purchase and sale of veterinary products can be separated from the sales of services and *de minimis* merchandise (for example, the taxpayer bills separately for the veterinary products, and the mixed services and *de minimis* merchandise, and, to the extent common payments are received, they are reasonably allocated between the separate bills).

A taxpayer using a hybrid method of accounting may operate as a single trade or business and may maintain a single set of books and records for such business.

Is Merchandise an Element in the Taxpayer's Business and Is It Income-Producing?

Historically, veterinary practices have been considered a service industry. However, as noted in Chapter 1, most practices act as a pharmacy since commercial pharmacies rarely have the required type or amount of pharmaceuticals for animals. Treas. Reg. sections 1.471-1 and 1.446-1(a)(4)(i) require accounting for inventories when the production, purchase, or sale of merchandise is an income-producing factor in the business. Items sold must be "merchandise" and an "income-producing factor," in order for the Commissioner to require the use of inventories.

The first step in this analysis is to determine whether the taxpayer has "merchandise." At this stage, it is important to distinguish between merchandise for sale and material/ supplies. The term "merchandise" is not defined within the Code or underlying regulations. However, in *Wilkinson-Beane, Inc.* v. *Commissioner*, 420 F.2d 352, 354 (1st Cir. 1970), the Court defined merchandise as tangible personal property held for sale. Based on the regulations and the case law, the Service has determined that for purposes of Treas. Reg. section 1.471-1, merchandise is property transferred to a customer (including property physically incorporated in that which is transferred to a customer), whereas materials and supplies are property consumed during the production of property or provision of services.

The next step in the analysis is to determine whether the production, purchase, or sale of such merchandise is an income producing factor in the taxpayer's business. In cases involving the provision of services and the transfer of related merchandise by a taxpayer, the courts have generally compared the cost of the merchandise purchased to the taxpayer's case method gross receipts. There is no bright line test with respect to when merchandise will be regarded as an income producing factor in a taxpayer's business. However, courts have found that merchandise is an income producing factor in a taxpayer's business where its cost is approximately 15 percent of the taxpayer's cash method gross receipts.

Below are listed some steps which may help determine if a veterinarian has inventory which is income-producing:

1. Purchases must be analyzed to determine what is bought throughout the year, and whether the purchased items are transferred to the veterinarian's customers. A small year-end balance is not an indication that inventory is insignificant and need not be considered. It also does not matter whether the customer is charged separately for items such as prescription drugs which may be delivered at the same time as the service or at a later date. If an item is consumed in the course of providing a service, it is more akin to a supply. Some examples of supplies are: alcohol, whippets, combs, tongue depressors, disposable syringes, rubber gloves, and like items. However, if the same supplies listed above are sold to the veterinarian's customers, they may still constitute inventory.

2. The cost of the inventory items purchased during the year should be compared with the taxpayer's cash method gross receipts in order to determine whether the production, purchase, or sale of merchandise is an income producing factor in the taxpayer's business.

   Note: Veterinarians are required to maintain inventory records on some controlled substances by the U.S. Drug Enforcement Agency and state drug enforcement agencies. A review of those records may be helpful in verifying balances.

If the production, purchase, or sale of merchandise is an income producing factor in the veterinarian's business, propose that the taxpayer change from cash to an accrual method of accounting. If the taxpayer keeps its books in such a way that the sale of merchandise is severable from the sale of services, propose a change to a hybrid method of accounting.

How a Taxpayer Requests a Change of Accounting Method (Form 3115)

The procedures for requesting a change in accounting method can be found in Rev. Proc. 97-27, 1997-1 C.B. 680. The three sections that specifically apply are as follows:

Section 5.	Procedures for Taxpayer Not Under Examination
Section 6.	Procedures for Taxpayers Under Examination, Before an Appeals Office, or Before a Federal Court
Section 8.	General Application Procedures

Chapter 3

Examination Techniques

General Techniques

The application of the general techniques discussed in this section will depend on the type of entity (individual, corporate, etc.) and on the classification of the entity (practitioner, facility, group). Additional considerations may be the ownership (closely held) and the size of the entity.

Auditing a small to medium size veterinary medical practice is much like an audit of any other type of corporation. The nature of the audit procedures selected and the extent of their application depends upon the degree of reliance that can be placed on their system of internal accounting controls. Many veterinary medical practice corporations are closely held and may have related parties working within the corporation. Inquiries into the corporation's accounting procedure and staff are a factor in determining the depth and scope of the audit.

Before beginning the audit, the following may be helpful in planning the depth and scope of the audit: Exhibit 3-1 is a sample Form 4564 Document Request to assist you in obtaining these records.

- Articles of incorporation, bylaws, and stock certificate book
- Minutes of board meetings
- Organizational chart
- Chart of accounts
- Contracts and agreements, such as leases and agreements
- Description of the accounting system and internal controls
- Loan agreements and other debt instruments and relationship to a debtor (education loans of shareholders)
- Copies of any prior audit reports by federal, state, or local agencies
- Copies of prior/subsequent returns and related returns
- Copy of pension plan, letter of determination, and F5500s

It is important to keep track of where you are in an examination, including what you have seen and what you have requested. Exhibit 3-2 is an Audit Plan containing a list of audit steps which may be appropriate. The plan is not all inclusive and should be modified for the taxpayer under examination.

Veterinary Office Procedures and Records

A thorough understanding of the accounting systems is particularly important in the veterinary medical industry. The records created (hard copy or magnetic media) by these types of systems may provide a valuable source of information in the examination of the veterinary medical practices. A complete explanation of the accounting system, both in theory and practice, should be obtained from the taxpayer prior to beginning the examination of the books and records.

The following procedures and records are typical for the office of a private veterinary medical practice:

1. The first record of customer visits to a veterinarian's office is the ***Appointment Book***. This will reflect the patient's name, and the date and time of visit. This information should link to the sign-in sheet and individual customer account record. This record will be only as accurate as the office chooses to keep it. It may reflect appointments that were canceled, and no show appointments. It is not an exact record by itself.
2. The ***Sign-in Sheet*** will reflect the customer's name and the date of the office visit. It is merely a record of each customer coming into the office, as some customers have appointments while others could be walk-ins. This record may not always link to the customer individual account record, as the amount charged each customer is not shown on it, and sometimes there may not be a charge for an office visit, such as for a surgery, follow-up visit.
3. The ***Day Sheet***, usually completed for each day, will reflect the date, customer name, patient charges, payments received on the particular day, and the method of payment. Some collections on account may be for a charge prior to the current day. It may also contain a reconciliation of the day's receipts, bank deposits, and checks written as well as the amount of accounts receivable outstanding at the end of the day. Any charge or collection reflected on the day sheet should tie to a corresponding entry on the customer account card. Since the day sheet usually shows all receipts for a given day, it should also reconcile to daily deposits.

4. A ***Statement of Procedures and Services***, the bill prepared at the time of service, will show the charge for each procedure and service provided, and will include the date and patient's name. These charges should be directly reflected on the individual customer's account.
5. The ***Customer Account Card or File*** will include all charges made to each customer, and all payments received on account. Receipts on account should be reflected in the income accounts of the books, and in bank deposits. Adjustments to the account, such as contractual allowances and discounts, should be reflected in the income or expense accounts of the books.
6. The ***Bank Accounts*** will reflect daily deposits, and should include both cash and checks. Generally, deposit slips will reflect the source of the deposit, checks from clients, and credit card receipts. Deposits should be traceable back to a customer account, and collections posted to customer accounts should be traceable to a deposit.

Veterinarians may receive payments under a variety of different names:

For individuals --	Dr. Jones, Dr. James Jones, Dr. J. Jones, etc.
For partnerships --	Drs. Jones, Smith, & White, Main Street Clinic, etc.
For corporations --	Dr. James Jones, P.C., Drs. Jones & Smith, P.C., Main Street Clinic, P.C., etc.

Initial Interview/ Internal Controls

A. Initial Interview

The initial interview is an extremely important element of any examination. Information provided during the initial interview can save significant time and effort in unnecessary examination steps. In addition to the general items usually covered, specific questions relating to the practice of veterinary medicine care practices should be included in the interview as noted in Chapters 1 and 2.

As an audit aid, Exhibit 3-3 includes a listing of specific questions which may be appropriate. The list is not all inclusive and some of the questions may not be pertinent in all examinations. The initial interview should be tailored to the taxpayer under examination.

B. Evaluating Internal Controls in a Small Business Environment

Internal controls are another area that must be explored during the initial interview in order to determine the accuracy and reliability of the taxpayer's books and records. Along with internal controls, consideration should be given to the taxpayer's financial status.

Control procedures in many small businesses are often weak or nonexistent. This may be due to cost factors, the lack of well-trained accounting staff or a lack of concern with this aspect of the business. Smaller businesses generally have a higher level of "control risk." Control risk is defined as the risk that a material misstatement could occur and it will not be prevented or detected on a timely basis by the business' internal control structure, policies, or procedures.

Evaluate the control structure of the business early in the examination process. The level of control risk should be assessed to determine the depth of the income probe. At a minimum, acquire a knowledge of how the business operates on a day-to-day basis. Furthermore, the veterinarian's financial position must be understood to evaluate the likelihood that the profitability of the business supports the taxpayer's financial status. See Chapter 4 for additional examination techniques.

Most of the knowledge needed to evaluate the control structure of the business is acquired through interviews of individuals having first hand knowledge of the business or thorough observations of the business operations.

The first area to explore is the control environment of the business. This is made up of many factors that affect the policies and procedures of the business. Such factors include management philosophy, management operating style, organizational structure, personnel policies, and external influences that can affect the business. A good first step is to draw up an overview of the business operations.

The second key area of internal control is the accounting system. Be familiar with the normal flow of each type of transaction including the accounting records which are involved in the processing and reporting of transactions. Generally, there are two significant elements to a transaction:

1. the recording of the transaction from its initiation to its inclusion in the financial statement, and
2. the flow of funds into or out of the business.

Control procedures are the last area. These are the policies and procedures established by management to achieve the objectives of the business. Separation of duties is the primary control procedure that should be documented. Many small businesses have one owner and no employees. Although no separation of duties can exist in this situation, other control procedures might be in place to assure accurate reporting of income and expenses. Formal control procedures are more likely to exist as the number of employees increases and the structure of the business becomes more complex.

In summary, a complete and thorough examination of the veterinarian practice cannot be undertaken without an overview of the entire operation. An in-depth review of the practice and the financial status of the owner/shareholder can only be accomplished through an evaluation and documentation of internal controls, including the control environment, the accounting system, and the control procedures.

Examination Techniques -- Balance Sheet

The following section outlines techniques which may be used in performing audits of veterinary medical practices. This section also highlights some of the issues commonly found during the examination. While not all issues will be evident in every examination, these descriptions can serve as guidelines in preplanning the examination.

A. Reconciliation of Books to Return

IRC section 446(a) requires conformity with book income. Book and taxable income must be compared and the differences reconciled. The starting point for the examination of books and records is the reconciliation of tax return to the books. There are numerous differences between Generally Accepted Accounting Principles (GAAP) used for book purposes and tax law. These differences for corporate taxpayers should appear on Schedule M-1 of the income tax return. Reconciliation can be accomplished by comparing the amount on line 1 of the Schedule M-1 to the net income per books and the amount on line 10 of Schedule M-1 to line 28 on page 1 of the return. Often, off-book entries are made to adjust book income. If this is the case, Schedule M-1 will not reconcile directly to the books and the taxpayer or representative will need to provide these entries. See sections "O" and "P" for additional techniques.

For individual taxpayers reporting on a Form 1040, Schedule C or partnership return, the reconciliation of the return to the books and records will usually be a memorandum item maintained by the return preparer.

B. Cash

Cash may include cash on hand, money in checking and savings accounts, time deposits, and other cash investments. Multiple checking accounts may be maintained by veterinary medical practices. A main checking account may be used for depositing daily client receipts, paying expenses, and disbursing refunds to clients while separate accounts are utilized for payroll or other purposes. Time deposits may be in the form of savings accounts, money market accounts, certificates of deposit, or similar accounts. Many times, transfers of funds occur among these accounts.

WHAT TO LOOK FOR	***WHAT TO CONSIDER***
1. Recently drawn checks that have not been issued. Check that the bank made payment.	1. Overstatement of expenses in the current year (Cash-basis dates taxpayer).
2. Checks with unusual endorsements; officers, partners shareholders, etc.	2. Unauthorized withdrawal, diversion of funds.
3. Review sequence of numbers for several months and note any missing numbers.	3. Diversion/withdrawal of income.
4. Unusual entries in the cash ledger account or cash receipts journal.	4. Sales of assets not recorded on the books or omission of income.
5. Check interest earned CD's or brokerage accounts.	5. Possible omission from income.

C. Accounts Receivable

The method of reporting revenue must be determined. In closely-held situations, inclusion of loans to related parties in receivables should be considered.

There are companies which will purchase the receivables of veterinary medical practices. Any sale of receivables should be reviewed to insure correct reporting of income based on the taxpayer's method of accounting.

Analyze accounts by the following categories: customer accounts, affiliated companies, shareholders, officers, and employees.

WHAT TO LOOK FOR	***WHAT TO CONSIDER***
1. Interest-bearing notes.	1. Interest properly recorded?
2. Credit balances on the trial balance or in the subsidiary receivable ledger.	2. Deposits or overpayments, additional income or unrecorded sales.
3. Loans to officer/shareholders, affiliates or other related parties.	3. Possible disguised dividend or compensation.
4. Receivables on installment sales.	4. Interest should be reported as collected.
5. Credits to receivable accounts, other than collections and bad debts.	5. The offsetting debit means that an asset was received.
6. Check subsidiary ledger for unusual items, entries arising from other than sales or cash journals.	6. Unreported income.

D. Investments

Veterinarians often hold stocks, bonds, real estate (for example, farms), or other types of investments through their corporations.

WHAT TO LOOK FOR	WHAT TO CONSIDER
1. Review acquisitions.	1. Determine source of funds; omission of income.
2. Write-up or write-down to reflect market values.	2. The taxpayer is taking an unauthorized deduction on the tax return. Proper treatment is a M-1 entry.
3. Purchases and sales should be recorded at FMV; look to underlying journal entry to determine the sales price.	3. Correct income or loss should be reported; independent sources may have to be used to verify sales price.
4. Review investment income account and dividends and interest in conjunction with portfolio; review GL account for investments; increases or decreases.	4. Ensure sales and purchases are being picked up; ensure interest and dividends are properly recorded.
5. Test acquisitions to determine if basis was properly recorded.	5. Over or understatement of income.
6. Test dispositions to determine if gain or loss was properly recorded.	6. Over or understatement of income.
7. Sales of depreciable property to related parties; sales below FMV to shareholders.	7. Ordinary income to corp. or unallowable losses; sales below FMV are ordinary income (dividend) to the recipient.
8. Real estate holdings and no rents, or inadequate rents on a yearly basis.	8. The corporation may be carrying the personal residence of the shareholder; constructive dividends.
9. Investment account, for an accrual basis taxpayer; interest receipt dates.	9. Failure to set up the accruals from the interest receipt dates to the year end; omission of income.

E. Inventory

As previously discussed in Chapter 2, the veterinarian should analyze sales to determine whether the items purchased and their generation of income is material and should therefore be separately identified as inventory.

Remember inventory items frequently include medicine, drugs, feed supplements, as well as a large variety of pet items such as carriers, shampoos, collars, etc. Inventory versus supplies is a major issue in many situations.

WHAT TO LOOK FOR	***WHAT TO CONSIDER***
1. Inventory valuation method conforms to methods prescribed by IRC section 471 and the regulations thereunder (inventory write-downs Rev. Rul. 80-60, 1980-1 C.B. 97).	1. If nonconforming, over or understated inventories and over or understatement of income.
2. Compare prior and subsequent year inventory balances with current year balances and note any discrepancies.	2. Possibility of over/under statement of cost of goods sold and under/over statement of net income.
3. Are year-end purchases included in closing (ending) inventory?	3. If not, COGS is overstated and net income is understated.
4. Unauthorized changes in inventory valuation method.	4. The Commissioner may refuse to accept the unauthorized change. In addition, there is a possibility of a distortion of income if no IRC section 481(a) adjustment was taken into account.
5. Removal of inventory for personal use by owners.	5. Constructive dividend to shareholder and an increase in income to the corporation.
6. Check for gross profit variations.	6. Withdrawal of inventory for personal use, understatement of net income.
7. Notes or qualifying statement on financial statements with respect to inventories.	7. Change in valuation method (unauthorized), inventory write-downs, under or overstatement of inventory and net income.

F. Other Current Assets

WHAT TO LOOK FOR	WHAT TO CONSIDER
1. Review current and prior year balances along with subsequent year balances.	1. Account for large or unexplained variations, under or overstated income.
2. Determine the taxpayer's procedure for writeoff's; check cost basis.	2. Over or understated income.
3. Prepaid expenses are deductible in the year to which they apply; absence of prepaid expenses.	3. Understatement of income, improper handling of expenses; expenses may have been prematurely written-off.

G. Loans to Shareholders

As with other closely held corporations, loans to shareholders have potential for audit adjustment to both the corporation and the shareholder. The corporation represents a legal entity, separate and apart from the shareholders. The shareholders will look for ways to take money out of their corporation. Loans to shareholders may include advances paid in varying amounts over a continuing period. These advances may include the personal expenses of the shareholder paid by the corporation. In many instances, there may be no interest charge.

Loan agreements should be reviewed to determine if a bona fide creditor-debtor relationship exists between the corporation and the shareholder.

Items indicative of a true loan include:

1. Signed note.
2. Security or collateral given.
3. Definite repayment date.
4. Periodic repayments of prior withdrawals.
5. Interest charged and paid.
6. Shareholder has available funds to repay the outstanding balance.

Items indicative of a dividend:

1. No note or open account.
2. No security given.
3. No specified repayment date.
4. No repayments to date.
5. No interest charged.
6. Shareholder cannot repay his or her outstanding balance unless his or her interest in the corporation is liquidated.

Additional Considerations:

1. Closely-held corporations.
2. Poor dividend history.
3. Corporation's retained earnings account.
4. Efforts made by corporation to enforce collection.
5. Ultimate use of the funds borrowed.
6. Moderate compensation is paid to shareholders.
7. Withdrawals or advances are proportionate to stock holdings.
8. Whether the corporation had sufficient surplus to cover the amount withdrawn.

Beginning and ending balances for shareholder loan accounts should be verified to determine if a pattern of continually increasing balances is occurring. Even when bona fide loan agreements exist, such increases may represent dividends to the shareholder. If a distribution that was originally classified as a loan is found to no longer be a bona fide loan, the amount will be considered to be a distribution of property under Treas. Reg. section 1.301-1(m).

H. Real Estate and Fixed Depreciable Assets

In examining this account, a review of related reserve amounts, depreciation schedules, and other pertinent documents will be required. If necessary, consider engineering referrals.

A change to correct a taxpayer's improper depreciation method, recovery period, or convention for computing its depreciation deduction is a change in method of accounting to which the provisions of IRC sections 446 and 481 generally apply; as is a change to the allocation of basis between assets, the result of which simply changes the time or period over which the costs of the assets are recovered or taken into account.

WHAT TO LOOK FOR	WHAT TO CONSIDER
1. Review acquisitions to ascertain that basis has been properly recorded.	1. Over or understated income.
2. For asset acquisitions where other than cash was the consideration, determine how basis was arrived at.	2. Over or understated income.
3. Basis should include all expenditures required to place the asset in service.	3. Understated income.
4. Review retirement policy of fixed assets; proper recording of receipts from dispositions.	4. Understated income.
5. Write-up of assets to appraised value on the books.	5. Not permissible for tax purposes; overstated depreciation and understated income.
6. Prior Revenue Agent Reports (RARs) that capitalized items or changed the method.	6. The taxpayer must follow those changes in subsequent years.
7. IRC section 351 transfers of assets; transferee must use the transferor's basis.	7. Overstated depreciation and understated income.
8. Decreases in asset account balances during the year.	8. Sales have taken place; check for gain or loss; possible sale to shareholder at less than FMV; recapture.
9. Transfers of assets from shareholder to related corporation.	9. Under IRC section 351, the transferee must use the transferor's basis; be alert to inflated basis and inflated depreciation deductions followed by understated income.

I. Intangible Assets

Old Law:

On April 20, 1993, the Supreme Court held in *Newark Morning Ledger Co.* v. *United States*, 507 U.S. 546 (1993), that customer-based intangible assets acquired incident to the purchase of an ongoing business are depreciable if the taxpayer can identify the asset and demonstrate that the asset has an ascertainable value and a limited useful life which can be determined with reasonable accuracy. The government had argued that intangible assets that are valued based upon future revenue from continuing at will relationships are nonamortizable goodwill as a matter of law.

The burden of proof remains with the taxpayer to show ascertainable value and a limited useful life which can be determined with reasonable accuracy. Because the government did not contest the life and value issues in *Newark Morning Ledger Co.*, choosing instead to focus on the goodwill argument, the case should not be read as sanctioning any particular method of valuation or the existence of value or limited life for any asset or type of asset. These issues must be decided based on the facts in each case. The Industry Specialization Program paper on customer-based intangibles for all industries, issued February 19, 1996, should also be consulted when examining such intangibles.

New Law:

The Omnibus Budget Reconciliation Act of 1993 was signed into law on August 10, 1993. The Act provides that most acquired intangible assets are to be amortized over a 15-year period. These IRC section 197 intangibles include goodwill, going concern value, customer lists, core deposits, know-how, information base, workforce in place, covenants not to compete, and similar agreements. The Act generally applies to property acquired after the date of enactment, but provides the taxpayer an election whereby it may apply to all property acquired after July 25, 1991, and before the date of enactment. This election, if made, would include all related parties and apply to any acquisition reported on the electing entity's consolidated return.

J. Changing a Taxpayer's Method of Accounting

A change to correct a taxpayer's improper amortization method, recovery period, or convention for computing its amortization deductions is a change in method of accounting to which the provisions of IRC sections 446 and 481 generally apply; as is a change to the allocation of basis between assets, the result of which simply changes the time or period over which the costs of the assets are recovered or taken into account.

WHAT TO LOOK FOR	WHAT TO CONSIDER
1. Basis of asset should include all elements of cost; legal fees, application fees, and proper costs of acquisition.	1. Under or overstated income.
2. Goodwill, going concern, workforce in place, information base, know-how, customer-based intangibles, supplier-based intangibles, government licenses and permits, franchises, trademarks and trade names.	2. IRC section 197 intangibles (see above).
3. Covenants not to compete; computer software; copyrights and patents, sound recordings, video tapes, film, and books.	3. Treated as IRC section 197 intangibles only if acquired in connection with the acquisition of a business. Otherwise, amortizable under IRC section 167.
4. Organizational expenses.	4. Amortizable over 60 months or more, not currently deductible.
5. Lease acquisition costs.	5. Amortized over lease term. Check for renewal option and over/understated amortization.
6. Lessee Improvements.	6. Improvements to real property subject to the Modified Accelerated Cost Recovery System. Recovery period is generally the same as property to which the improvement was made.
7. Exchange, clearing, or suspense accounts; question why the accounts were set up and for what purpose.	7. Possible diversion of income, inflated expenses, loans to shareholders. Over/understatement of income.
8. R & D expenditures taken as a current year deduction or capitalized; check for proper amortization.	8. Over/understated income.
9. Request engineering services when applicable.	9. Determination of correct valuation of asset acquired.

K. Liabilities - Current and Accrued

WHAT TO LOOK FOR	WHAT TO CONSIDER
1. Large expenses charged to the first month of the tax year under exam.	1. These expenses may have been accruable for the preceding tax year.
2. Security Deposits.	2. If applied to last month's rent, then taxable upon receipt.
3. Year-end accruals and reversals including purchases. Purchases should be included in ending inventory. Acceleration of subsequent expenses into current year. Review invoices.	3. Determine propriety of year-end accruals; were actual expenses incurred, and for what amount; were accruals actually charged to expenses in the subsequent period. Net income will be understated; distortion of income.
4. Read minutes, being alert for contingent liabilities.	4. If an accrual was set up, consider IRC section 461 for proper year of deduction; expenses can not be contingent, must be fixed, and the amount reasonably determinable.
5. Accounts payable -- tie in trial balance to general ledger; check for adjusting entries or reclassification and netting of related accounts receivable.	5. Potential unreported income; understatement of sales.

L. Loans From Shareholders

WHAT TO LOOK FOR	WHAT TO CONSIDER
1. Large liabilities in relation to capital stock (especially with a new company). Thin capitalization exists.	1. Thin capitalization. Disallow interest expense and treat payments to the shareholder as dividends.
2. The loan is not a bona fide debt and the shareholder took a bad debt deduction.	2. In addition to Item 1 above, disallow the bad debt deduction.

M. Deferred Credits

WHAT TO LOOK FOR	***WHAT TO CONSIDER***
1. Credit balance accounts, reserve accounts, contra-balance in receivables.	1. Deferred credits exit. The taxpayer has the free and unrestricted use of assets. Income should be recorded. Cash or accrual basis is irrelevant.
2. Installment method of reporting income. The deferred credit recorded will be the unrecognized gain for tax purposes. Check year-end balances to determine if the amount reconciles with the gross profit to be reported.	2. Should be a Schedule M-1 entry. Possible under/overstatement of income.

N. Capital Stock

WHAT TO LOOK FOR	***WHAT TO CONSIDER***
1. New issues or additions.	1. Was stock issued for services rendered or for property? Check for FMV and gains/losses to shareholder.
2. Reduction or cancellation of stock, by complete or partial liquidation.	2. Determine recipient's basis and gain/loss if it is a taxable transaction. Refer to IRC sections 337, 338, 1245 -- depreciation recapture.

O. Retained Earnings

WHAT TO LOOK FOR	WHAT TO CONSIDER
1. Reconcile income per books with income per tax return (go back to general ledger, not just the balance sheet).	1. Note any differences and review those that present tax problems.
2. Reconcile opening balance with year-end balance.	2. Investigate increases or decreases. Credit items may be income items.
3. Determine if there is an unreasonable accumulation of funds.	3. Consider imposition of IRC section 531, accumulated earnings tax.

P. Schedule M-1

Schedule M-1 items normally will be groupings of many amounts. In order to adequately consider these adjustments, detailed schedules showing each individual adjustment should be obtained. Analyze prior and subsequent year adjustments in conjunction with the current year and verify that all timing adjustments have been reversed in subsequent periods.

Items to look for:

Line 4 -- advanced rental income, other advance payments, that is, service contracts.
Line 5 -- depreciation variances, deferred compensation, self-insurance, IRS penalties, contingent liabilities, inventory adjustments, officers' life insurance, limitation on meals and entertainment.
Line 7 -- IRS adjustments, tax-exempt interest, deferred service income.
Line 8 -- depreciation variances, deferred research and development costs, capitalized interest and tax during construction.

Q. Schedule M-2

1. Reconcile income per books with income per return. (Schedule M-2, line 2 equals Schedule M-1, line 1)
2. Reconcile opening balance with prior year end balance. (Schedule M-2, line 1)
3. Analyze all increases and decreases.
4. Verify that no deduction has been claimed for expenses related to stock dividends. (Schedule M-2 line 5b and line 6)
5. Determine that income items recorded as credits have been properly included in income. For example: recovery of bad debt, prior period adjustments.
6. Consider imposition of IRC section 531 tax. (Accumulated earnings, greater than $250,000 or greater than $150,000 if a PSC)
7. Reconcile ending balance to book balance.

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Exhibit 3-1
Form 4564 Information Document Request

Form 4564	**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

In general, the records and documents that will be required to complete your examination include all of the records, journals, ledgers, logs, worksheets/schedules, third party statements, receipts, etc. that you used when preparing your ________ return.

For assistance, below is a list of specific items pertaining to your examination. Other documentation may be requested on an as needed basis.

1. Copy of the following items for inspection:
   a. Prior and subsequent year Federal Income Tax Returns, including any amendments.
   b. State Income Tax and State Sales Tax returns.
   c. Officer/stockholders' or partners' Form 1040 for the year under examination, prior and subsequent years.
   d. Related corporate returns, <u>that is</u>, subsidiary, parent, brother/sister.
   e. Related partnership returns.
   f. Payroll tax returns including Forms 940, 941, and State payroll tax records for all quarters encompassing the year under examination.
   g. Forms W-2 and 1099 issued for year under examination.
   h. Forms W-4 or W-9 for all workers.
   i. If previously examined, copy of prior Revenue Agent Report.
   j. Pension profits/sharing plan including determination letter and Form 5500 or the year under examination.

2. Corporate Minute Book or Partnership Agreement.

3. Working Trial Balance with a Chart of Accounts, including all adjusting/closing journal entries and accountant's workpapers.

4. Ledgers and Journals as follows:
   a. General Leder.
   b. All subsidiary ledgers.
   c. General Journal - including payroll.
   d. Cash Disbursments.
   e. Cash Receipts.
   f. Voucher payables.
   g. Sales.
   h. Purchases.
   i Any other special journals maintained.

Information Due By__________ **At Next Appointment [ ] Mail In [ ]**		
FROM:	**Name and Title of Requester**	**Date**
	Office Location	

Form 4564	**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

5. All journals, records and workpapers for the year under examination pertaining to Business Gross Receipts, but not limited to:
   a. Appointment books.
   b. Sign-in sheets.
   c. Day sheets.
   d. Bank statements for all accounts.
   e. Cancelled checks for all accounts.
   f. Money market, brokerage and investment statements for all accounts.

6. Record of any loans and repayments during the year under examination.

7. Detailed depreciation schedules.

8. All journals, records and workpapers for the year under examination pertaining to Cost of Goods Sold including, but not limited to:
   a. Beginning and ending year inventory valuation, count, dates of inventory verification.
   b. Inventory purchased.
   c. Removal of items for personal use.
   d. Cost of Labor.
   e. Purchase of materials and supplies.
   f. Other costs.

Note: If no Cost of Goods Sold appears on the return, please complete the following steps in preparation for the examination.

1. Analyze purchases to determine what is bought throughout the year, and how the purchased items should be classified - as a supply or as inventory. If the item is consumed in the course of providing a service, it is more akin to a supply. Some examples of supplies are: alcohol, whippets, combs, tongue depressors, diposable syringes, rubber gloves and like items. (If, however, the same supplies listed above are sold to the veterinarian's customers, they may still constitute inventory.) Some examples of inventory are: medication or drugs, pet foods, bandages, livestock antibiotic food additives, vaccination tags, pet containers and supplies such as collars and leashes. (It also does not matter whether the patient is charged separately for items such as prescription drugs which may be delivered at the same time as the service or at a later date.)

2. The current year end balance should be determined. It should include not only the amount, but also the specific items included in this calculation.

3. Compute the total amount of gross receipts from inventory. Compare that figure to total gross receipts arriving at a percentage of income from the sale of inventory.

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

FROM:	**Name and Title of Requester**	**Date**
	Office Location	

Exhibit 3-2

Taxpayer Name:

Form: **Year:**

AUDIT PLAN

Date	Item	Document Request #			
	1. Initial Interview Internal Control Conclusion				
	2. Read Corporate Minute Book				
	3. Reconcile stock ownership				
	4. Complete 3-year analysis				
	5. Reconcile books to return				
	6. Reconcile cash to balance sheet				
	7. Review M-1 and M-2 schedules				
	8. Peruse adjusting entries				
	9. Peruse financial statements				
	10. Compare 941's to Wages and Taxes				
	11. Peruse related returns, sub years				
	12. Peruse pension/profit sharing plan				
	12a. Complete Form 4632 and 4632-A				
	13. Peruse Books				
	13a. General Journal				
	13b. Sales reversals				
	13c. Comparative Statements				
	14. Refine audit plan -- select items				
	15. Complete Gross Income Probe				
	16. Peruse canceled checks				
	16a. Additional banks				
	16b. Foreign activities				
	16c. Related transactions				
	17. Special Issues - Employment Tax				
	18. Related Party Transactions IRC sections 7872, 461, and 267(a)				

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Exhibit 3-3

Taxpayer Name:

Form: **Year:**

Initial Interview Questionnaire

Every audit should include a tour of the taxpayer's facilities. Is the business still located at the address on the return? Are there any other locations?

If the Entity is a Corporation:

1. Ask the taxpayer to explain the corporation's history.

   Date incorporated: State:

   How did the business start?

   Sole proprietorship, S-Corp, C-Corp, Partnership, purchase of stock from third party, IRC section 351 transfer?

   Any changes in entity? (Possible built-in gains)

2. Are the present officers-stockholders the incorporators?

3. Who are the current officers-stockholders responsible for the corporation's management? (Executive, financial, sales, and services)

4. What is the percentage of corporate ownership of each officer?

5. What is the percentage of each officer's/stockholder's time devoted to the corporation's business?

6. Have their ownership percentages and duties remained constant?

7. How is compensation of officers-stockholders determined? (Salary plus bonus? Other fringe benefits?)

8. Does the corporation own or lease passenger or recreational vehicles? If yes, to whom are these vehicles assigned? How are business purpose and expenses documented?

9. Are immediate family members or close relatives employed by the corporation?

NOTES:

Financial Operations

Explain the financial operations of the business, including the accounting system, types of records maintained, and internal controls.

1. Is there an organizational chart? If not, describe in a general manner the organization of the accounting department, that is, the lines of responsibility.

2. Who should be contacted to obtain books, records, documents needed during the examination? Is there an office manager?

3. What books and records are kept? Chart of accounts used? Double entry books used?

4. Who keeps the books and records? Who adjusts and closes the books? Who reconciles bank accounts? Are proper cutoffs observed at month-end and year-end? Are adjusting and closing entries available?

5. When are financial statements prepared? (monthly, annually) Who prepares them? What information is in the statements?

   Have financial statements been given to others, such as banks, creditors, other businesses, etc.? Why? (Obtain copies)

   Have the financial statements been restated for any reason?

   Were the corporation's financial statements for the last 3 years audited by a public accountant?

   If yes, were certified financial statements issued? (Obtain copies)

6. Is the accounting software a commercial product?
   Name?

   Do you receive technical support from the company for any problems encountered or are the problems fixed in-house? If in-house, by whom?

7. Does the taxpayer use the services of an accounting firm? Does the accounting firm also provide management and consulting services?

   How does the accounting firm bill? (Annual retainer fee, retainer plus specific items fee basis, or specific item fee only)

   Has the taxpayer changed CPA's? If so, why?

8. Have there been any prior audits by any federal, state, or other governmental agency?

NOTES:

Business Operations

Describe the business operations during the year under exam, and what, if any, changes have occurred.

1. Is the practice specialized? Does the practice experience seasonal fluctuations?

2. Is the practice affiliated with any other veterinarians, clinics, emergency rooms, or hospitals?

3. Does the practice have a combined purchasing arrangement for inventory or supplies?

4. Who are the principal customers?
   Has the business changed its means of producing income since incorporation?
   How is new business obtained?

5. Do all veterinarians in the practice provide the same type of medical care?

6. Have there been any unusual or extraordinary events during the last three years? (Reorganizations, acquisitions, dispositions, or decline in income due to casualty, loss of prime client or supplier, or other economic or business conditions.)

7. Have you constructed or renovated any office, surgery, or animal holding facility? (capitalize interest)

8. Are there any plans in the future to expand or remodel?

9. Does the practice own or rent the building?
   Is any part of the building leased to an independent contractor?
   Is any portion of the building used for personal use?

10. Are the assets used in the business owned or leased? (That is, tables, chairs, desks, x-ray equipment)
    Is there an option to purchase?

11. How are appointments scheduled?
    Is daily log or day sheet maintained?

12. What are the billing practices? (When services are rendered, monthly, or after insurance reimbursement?) Are all invoices pre-numbered, and are all numbers accounted for and used in sequence?

13. What kind of inventories and supplies are kept on hand?

    How are sales of inventory billed? (Billed separately or as part of other services rendered?) (Is there a fee structure for high volume customers?)

    Are they inventoried for book and/or tax purposes?
    If not, why not?
    If so, what is included?
    Are physical inventories conducted?
    What records are available?

14. Who opens the mail for the office or clinic?

15. Is <u>all</u> cash received deposited?
    If not, what is it used for and how is it accounted for?
    Are any personal expenses paid by cash?
    Are all checks deposited into the business account?
    If not, what is procedure for check cashing?
    How are non-deposited checks accounted for?
    Who cashes checks?
    Where are they cashed? (bank, check cashing business, other)
    What is the cash used for?
    Who makes deposits?
    How far away is the bank?
    Are duplicate deposit slips kept?

16. How is petty cash handled?
    How are day accounts receivables handled?
    How are credit card payments handled?

17. Who authorizes the purchase of major items?
    Who authorizes write-offs?

18. Are personal funds of shareholders and officers kept completely separate from business funds? Have the taxpayer/representative walk through a complete income transaction and a complete expense transaction. Prepare a flowchart as each is being described.

NOTES:

Other Sources of Income

1. Are any of the veterinarians involved in lecturing, teaching, or speaking engagements? Fee scale?

2. Have any receivables been sold?
   If so, provide full explanation and documentation?

3. Referral of patients to labs, clinics, emergency rooms, diagnostic centers (MRI, etc.), pharmacies?

   Was any remuneration in the form of cash or other incentives received from the referral?

   Is an interest owned in any operation to which referrals are made?

4. Is there a pharmacy located in the facility?

5. Is medication administered or prescribed by the veterinarian?
   Cash payments or other incentives or benefits from drug companies?

6. Contracts with zoos, government agencies, unions, schools, or other organizations to provide veterinary medical services?

7. Payment to veterinarians by corporation for services other than medical services? (Directors' fees, etc?)

8. Do you perform surgery, etc. after hours?

9. Does the company furnish services in exchange for goods or services?

10. Have they ever received a cash payment of more than $10,000?
    Was it all deposited?
    Were Forms 8300 filed? (Secure copies).

NOTES:

Employment Practices

1. How many employees?
   Number and type of veterinarians on payroll:
   Number and type of others:

2. Number of assistants employed? Any student assistants?

3. Any contract workers?
   If yes, determine if contract workers are employees or self-employed.

   For information concerning this subject, see "Independent Contractor or Employee?", Training 3320-102 (Rev. 10-96) TPDS 84238I.

4. How are payrolls handled?
   Have all payroll returns been filed to date?

5. Are 1099s issued to individuals for payments of $600 or more?

6. When does the practice secure SSN's (W-4, W-9)?
   Have they ever received a notification letter from the IRS regarding no/invalid SSN/EIN number? If yes, what action was taken?

7. Are any incentives (recruiting or other) provided to or received by veterinarians or other providers? If so, what type, who provided them and how are they reported?

   (Examples: interest-free loans; below-market interest rate loans; loan forgiveness; rent, purchase, or other payment in excess of fair market value [to veterinarian/shareholder]; provision of office and staff rent-free or below fair rental value; payment of personal expenses; repayment of student loans or other educational liabilities; income guarantees; bargain sales to veterinarians; payment of malpractice premiums; or malpractice payments not covered by insurance)

8. Did the taxpayer (or shareholders) attend medical school on a scholarship?
   If so, did they complete the required service?

   If the required service was not completed, has the scholarship been repaid with the required penalties?

   Have any amounts been expensed through the corporation?

   Did the taxpayer obtain a student loan (government or private) to attend undergraduate or veterinarian school? Repayment history?

   Have any amounts been expensed through the corporation?

NOTES:

Chapter 4

Industry Issue Techniques

Entity, Tax Year, and Accounting Method Issues

As noted in Chapter 2, the taxpayer has many choices in setting up their business. Look for the following issues:

A. Personal Service Corporations

Rev. Rul. 91-30, 1991-1 C.B. 72, holds that a corporation whose employees perform veterinary services is a "qualified personal service corporation" (QPSC) under IRC sections 448(d)(2) and 11(b)(2).

1. Was 35 percent corporate rate used?
2. Calendar year required unless permission received.
3. Were Passive Activity Losses limited?

B. Determination of a Tax Year

1. Substantial Business Purpose Determined?
2. Form 1128 filed?
3. Permission received?
4. For which year is it applicable?

C. Method of Accounting

If the taxpayer is using a cash or hybrid method of accounting, determine whether the taxpayer is required to use inventory accounting; that is, whether the production, purchase, or sale of merchandise is an income producing factor in the taxpayer's business. If so, the taxpayer must use an accrual method for purchases and sales of such merchandise and any related services.

1. **Is merchandise an element in the taxpayer's business?**

   Based on the regulations and the case law, the Service has determined that for purposes of Treas. Reg. section 1.471-1, merchandise is property transferred to a customer (including property physically incorporated in that which is transferred to a customer), whereas materials and supplies are property consumed during the production of property or provisions of services.

2. **Is it income producing?**

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

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

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

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

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

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

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

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

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

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

Balance Sheet Issues

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

A. Intangibles

1. **Customer records**

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

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

2. **Covenant not to compete**

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

3. **Purchase of a veterinarian practice**

An issue that may be present is the over valuation of tangible assets and the under valuation of intangible assets, which accelerates the taxpayer's recovery of its costs through depreciation deductions for assets with shorter recovery periods. A change to the allocation of basis between intangible and tangible assets, the result of which simply changes the time or period over which the costs of the assets are recovered or taken into account, is a change in method of accounting to which the provisions of IRC sections 446 and 481 generally apply.

B. Loans to Shareholders

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

1. **Potential imputed interest**

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

2. **Loan or a dividend distribution**

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

Income Issues

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

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

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

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

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

A. Gross Receipts

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

B. Additional Income Issues

1. **Sale of veterinarian practice**

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

2. **Passive income recharacterization**

   a. Per IRC section 469(a)(2)(B), a PSC cannot offset passive losses against their active income.

   b. Self-Rented Real Estate --

      > Does the taxpayer materially participate in the entity renting from the taxpayer?

      > Is the entity renting the property anything other than a C Corporation?

      > If the corporation rents its building from a shareholder, determine whether it is under a net lease (corporation pays most of the expenses except interest, taxes, and depreciation).

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

      Additional Considerations:

      > Is rent at a fair market value?

      > Is subletting recorded as income on the tax return?

      > Is there any personal use of the building space?

   c. Self-Rented Equipment

      > Is rent at a fair market value?

      > Is there any personal use?

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

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

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

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

Expense Issues

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

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

When applying the reasonableness standard, take into account *Robert N. Noyce and Ann S. Bowers Noyce* v. *Commissioner*, 97 T.C. 670 (1991). In this case the judge agreed that the "reasonableness" standard only applies to unreimbursed expenses other than depreciation. Depreciation is not subject to the reasonable standard because it is not deducted under IRC section 162 and therefore does not have to meet the requirements of that section.

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

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

A. Lease Versus Purchase

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

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

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

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

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

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

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

B. Automobile Expense

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

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

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

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

C. Entertainment, Travel, and Meals

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

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

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

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

Constructive Dividends/Fringe Benefits

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

A. Loans to Shareholders

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

B. Payments for the Shareholder's Benefit

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

C. Excessive Compensation/Rents/ Interest

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

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

2. Determine if and to what extent each principal officer's compensation is unreasonable by taking into account the following factors: nature of duties, background and experience, knowledge of the business, size of the business, individual's contribution to profit making, time devoted, economic conditions in general, character and amount of responsibility, time of year compensation is determined, relationship of the stockholder/officer's compensation to stockholdings, whether alleged compensation is in reality, in whole or in part, payment for a business or assets acquired, and the amount paid by similar size businesses in the same area to equally qualified employees for similar services. Also, see the section on Inadequate Compensation in this chapter.

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

D. Shareholder Use of Corporate Property

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

E. Bargain Purchases

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

F. Insurance Expense and Split Dollar Policies

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

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

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

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

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

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

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

Valuation of Fringe Benefits

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

A. General Rule - Fair Market Value (FMV)

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

B. Automobile Lease Valuation Rule

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

C. Cents-Per-Mile Valuation Rule

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

D. Commuting Valuation Rule

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

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

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

   a. Is a board-appointed, shareholder-appointed, confirmed, or elected officer of the employer whose compensation equals or exceeds $50,000 as indexed ($72,500 for 1998);
   b. Is a director of the employer;
   c. Owns an 1 percent or greater equity, capital, or profit interest in the employer, or;
   d. Receives annual compensation of more that $100,000 as indexed ($145,000 for 1998).

Employment Tax Implications of Fringe Benefits

A. General Rule

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

B. Special Rule for Non-Cash Fringe Benefits

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

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

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

Additional Tax Issues

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

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

Questions to consider:

1. Was it a C corporation prior to making its S corporation election?
2. Was the S corporation election made after 1986?
3. Does it have a net recognized built-in gain within the recognition period?
4. Check to see that the net recognized built-in gain for the tax year does not exceed the net unrealized built-in gain minus the net recognized built-in gain for the prior years in the recognition period that were subject to tax.

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

Whipsaw Issue:

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

B. Accumulated Earnings Tax -- IRC section 531

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

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

Retirement Plans

In response to tightened provisions relating to pension plan funding for highly compensated key employees, a funding vehicle has evolved which purports to be an employee welfare benefit plan. When analyzed, these plans are often highly funded plans designed to provide benefits primarily to the highly compensated employees of closely-held corporations. These plans may be either non-qualified deferred compensation arrangements (in which case the employer's contribution would be deductible in accordance with IRC section 404(a)(5)), or welfare benefit plans (in which case the employer's contribution would be deductible in

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

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

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

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

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

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

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

Employer contributions are generally invested entirely in life insurance contracts on the lives of covered employees. For those arrangements that provide benefits in addition to life insurance, the benefits are allegedly funded through the cash value of these policies. The arrangements also allow for a distribution of the policies and/or cash values to the employees when the employer terminates its participation in the plan. The so-called "death benefit only" arrangements generally purchase life insurance policies on key employees which possess features which allow for the build-up of "credits" (as opposed to cash value) which, upon conversion from a trust-owned policy to an individually-owned policy, generate a significant cash value. This type of policy has traditionally been referred to as a "springing cash value" policy.

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

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

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

How to determine if this is an issue:

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

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

3. If the taxpayer made a contribution to such an arrangement, secure a copy of the adoption agreement, the plan document, the trust agreement, the provisions of the plan, the Summary Plan Description, the life insurance policies, etc. The National 419/419A/VEBA issue specialist has a pro-forma IDR in this regard.

Contact the National 419/419A/VEBA issue specialist to ensure the proper development and resolution of this issue.

Excessive/Inadequate Compensation

In a C corporation, excessive compensation may be paid to shareholder/employees as a means to avoid paying the second-tier tax on dividends. Because S corporation distributions of earnings are generally not subject to second-tier tax on dividends, whether a shareholder has received excessive compensation is generally irrelevant. Indeed, since only amounts paid as wages are subject to employment taxes, S corporations have an incentive to distribute earnings as dividends and pay inadequate compensation to their shareholder/employees.

The first inadequate compensation case of an S corporation to be litigated was *Walter J. Roob and Mary S. Roob* v. *Commissioner*, 50 T.C. 91 (1968) where the Court agreed that the salaries paid to both the husband and wife were inadequate for the long hours worked in performing not only managerial functions, but also sales activities. The income reallocated to the husband was considered dividend income (even though the basis for reallocation was an inadequate salary), and therefore, the reallocated income was not deductible by the corporation.

The factors deemed relevant in deciding inadequate compensation cases are the same ones deemed relevant for excessive compensation. They are as follows:

A. Employee's Qualifications

The qualification of an employee for the position bears a direct relationship to the reasonableness of his or her salary. In determining the reasonableness of salary, the employee's background, experience, and accomplishments should be given consideration. The fact that a taxpayer's business is extremely successful compared to competitors may be evidence of employee's qualifications and tend to show reasonableness. See *Van's Chevrolet, Inc.* v. *Commissioner*, T.C. Memo., 1967-172, CCH 28,583(M).

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

B. Nature, Extent, and Scope of Work

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

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

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

C. Employer's Salary Scale

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

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

D. Industry Compensation Rates

A valid method of determining the reasonableness of a shareholder's salary is to compare it with salaries of non-owner executives who have similar responsibilities in similar companies, during the same time period. The taxpayer often asserts that the company chosen for comparison is substantially different, or is more/less successful, or in a more or less competitive market. Similarly, a taxpayer may assert that the comparative executive is represented to be more than a manager, for example, an inventor, key salesman, or founder of the company, etc.

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

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

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

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

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

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

E. Size and Complexity of the Business

The size of the business and complexity of operations may be considered in ascertaining the reasonableness of compensation paid to the shareholder/employee(s). Presumably, larger businesses engaging in more complex operations would be required to pay larger salaries. Size may be established by reference to the amount of annual revenue, gross profit, operating expenses, and net income as well as reported assets and net worth. Complexity of operations may depend on a number of factors including, but not limited to, the amount of the business activities and the organizational structure.

F. Compensation-to-Income Ratio

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

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

G. General Economic Conditions

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

H. Prior Compensation and Compensation Compared to Dividends

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

Take care in addressing this point if made by the taxpayer. Was there a pre-existing written agreement or some written authorization by the Board of Directors to approve paying additional compensation to make up for underpaid years?

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

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

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

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

I. Case Histories

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

1. In *C.D. Ulrich, Ltd.* v. *United States*, 692 F. Supp. 1053 (D. Minn. 1988), the taxpayer, a CPA and sole shareholder, reported all monies received from the S corporation as distributions. As a result, he received no salary for the years cited. The taxpayer argued he was not an employee for employment tax purposes since he had no supervisors and set his own work schedule. Because the taxpayer had provided more than minor services, however, the court deemed him to be an employee of the corporations subject to federal employment taxes.

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

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

4. *Spicer Accounting, Inc.* v. *United States*, 918 F.2d 90 (9th Cir. 1990) involved an accounting firm controlled by the taxpayer, who was the president, treasurer, and director. In addition, the taxpayer and his wife were the only shareholders of the S corporation. The taxpayer was never paid a salary by the corporation, but "donated" his services to the corporation and withdrew earnings in the form of dividends.

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

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Exhibit 4-1

Internal Revenue Service
Field Examination

Department of the Treasury
Address any reply to:

Person to Contact:

Telephone Number:

Refer Reply to:

Date:

___

Dear Sirs:

In accordance with Revenue Procedure 97-27, Section 3.08, this letter is to officially notify you of an issue under consideration involving a method of accounting. The issue under consideration involves the incorrect classification of nonresidential real property under the depreciation rules of IRC section 168.

Internal Revenue Code section 168 requires nonresidential real property to be depreciated using a recovery period of 31.5 years. Such incorrect misclassification of property is a method of accounting because it affects the timing of the deduction and not the total amount of depreciation.

In order to discuss this matter and to review the books and records requested on the attached Document Request, please call to schedule an appointment.

Thank you for your consideration of this matter.

Sincerely,

Revenue Agent

Note to Examiner:

The first paragraph contains all the elements necessary to place the accounting method issue for an item "under consideration" for purposes of Rev. Proc. 97-27.

To the extent you have determined the proper method of accounting, it is helpful to include it in the notification, as done in the second paragraph. However, it is not necessary to do so to place the accounting method issue "under consideration."

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Exhibit 4-2

American Veterinary Medical Association Compensation Survey

Abstract from the Journal of the American Veterinary Medical Association, March and April 15, 1997, Volume 210.

Professional Income for Owners of Private Practices in 1993 and 1995.

Practice Type	*1993 Average $*	*1995 Average $*
Large Animal		
exclusive	66,539	69,055
predominant	61,118	62,645
Mixed	51,657	57,346
Small Animal		
exclusive	77,190	74,940
predominant	67,955	88,313
Equine	78,316	75,076

Professional Income for Associate Veterinarians in Private Clinical Practice in 1993 and 1995.

Practice Type	*1993 Average $*	*1995 Average $*
Large Animal		
exclusive	46,123	51,029
predominant	42,471	43,669
Mixed	37,741	40,063
Small Animal		
exclusive	43,049	49,953
predominant	47,877	43,196
Equine	45,797	46,225

Median Professional Income of Veterinarians Employed by Public or Corporate Firms, Analyzed by Years since Graduation and Type of Employer.

Years since graduation	*** UNI $**	**FED $**	**SLG $**	**UPS $**	**IND $**	**OTH $**
1 - 2	23,500			35,300		
3 - 7	23,500	47,500	47,500	41,500	50,500	32,500
8 - 12	53,500	53,500	47,500	53,500	65,500	47,500
13 - 17	61,000	59,500	50,500	59,500	80,500	53,500
18 - 22	71,500	59,500	53,500	68,500	108,000	65,500
23 - 27	80,500	61,000	59,500	77,500	104,000	
28 - 32	88,000	58,500	65,500	71,500	99,000	
33 - 40	95,751	59,500	62,500		120,000	90,050

* UNI=college or university; FED=federal government; SLG=state or local government; UPS=uniformed services; IND= industry; OTH=other

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Exhibit 4-3

Compensation Interview Questionnaire

1. What are your work hours?
2. What days do you work?
3. How long have you been working in this field?
4. What are your duties?
5. What percentage of your time is spent doing CEO duties versus practicing veterinary medicine?
6. Are there other corporate officers? What do they do? How much are they paid?
7. How do you determine your compensation during the year? When is it paid?
8. Have you always used the same method of determining your compensation? If not, what changes have you made?
9. What has been the trend of gross income for this practice?
10. Have there been any economic conditions that have affected the growth of the practice?
11. Do you receive a year-end bonus? How is it determined?
12. Do other employees also receive a year-end bonus?
13. Have you personally guaranteed any loans?
14. Has the corporation ever declared a dividend?
15. Are you involved in other businesses? If so, how much time is devoted?

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Appendix A

Glossary of Veterinary Medicine Terminology and Common Terms for the Industry

AABP -- American Association of Bovine Practitioners

AAEP -- American Association of Equine Practitioners

AAHA -- American Animal Hospital Association

AALS -- American Association of Laboratory Science

AASP -- American Association of Swine Practitioners

AASRP -- American Association of Small Ruminant Practitioners

accreditation -- the process of evaluating an institution or program for meeting specific criteria or standards.

acupuncture -- an Oriental system of therapy or anesthesia. Needles are inserted at critical places of the body that affect another part of the body.

accrual basis -- accounting method which recognizes revenue in the period in which the service is provided, regardless of when the cash is received, and recognizes expenses in the period in which the expenses are incurred, regardless of when they are paid.

AHT -- the abbreviation for Animal Health Technician, the widely used term for Animal Technician or Veterinary Technician.

allowance for uncollectibles -- bad debt service.

ancillary services -- those services other than room, board, and medical; such services as laboratory, radiology, pharmacy, and therapy services, that are provided to hospital patients in the course of care.

APHIS -- Animal and Plant Health Inspection Service, United States Department of Agriculture

ASPCA -- American Society for the Prevention of Cruelty to Animals

assay -- to test or analyze.

avian -- birds.

AVMA -- American Veterinary Medical Association

balm -- a soothing ointment.

beef bull -- a male animal which is part of the breeding herd for raising beef calves.

boar -- a male pig which is part of the breeding herd for raising feeder pigs.

bovine -- pertaining to cattle and ox-like animals.

brand -- an iron used for burning marks on livestock. Each farmer's brand is unique; therefore, each herd can be distinguished from another.

breeding -- the mating of animals.

bred heifer -- a young, female dairy animal which has been bred to increase its resale value and is not used as part of a farmer's dairy herd.

brood cow -- a female animal which is part of the breeding herd for raising beef calves.

Brucellosis -- the contagious, infectious, and communicable disease caused by bacteria which affects cattle. It is also known as Banks disease, undulant fever, or contagious abortion.

bull -- the male of a bovine animal.

cafeteria plan -- a separate written plan maintained by an employer for the benefit of its employees, under which all participants are employees and each participant has the opportunity to select among

various benefits consisting of cash and certain nontaxable benefits (that is, accident and health insurance). Participants electing the nontaxable benefits under this arrangement will not have to include the available cash in gross income.

calf -- the young of a cow.

capital-related costs -- as defined in Public Health, 42 C.F.R. Section 405.414

1. Net depreciation expense -- adjusted by gains and losses realized from the disposal of depreciable assets.

2. Leases and rentals -- for the use of assets that would be depreciable if the provider owned them outright and other leasing arrangements.

3. Betterments and improvements -- that extend the estimated life of an asset at least two years beyond its original estimated useful life.

4. The cost of minor equipment that is capitalized rather than charged off to expense.

5. Interest expense incurred in acquiring land or depreciable assets used for patient care or in refinancing debt that was originally incurred to acquire land or depreciable assets used for patient care.

6. Insurance on depreciable assets used for patient care, or insurance that provides for the payment of capital-related costs during business interruption.

7. Taxes on land or depreciable assets used for patient care.

cash basis -- accounting method which recognizes revenue only in the accounting period when cash is received (actually or constructively), and expenses only in the period paid.

clinic -- where patients are examined and treated.

clinician -- a veterinarian in clinical practice as distinguished from a veterinarian in researching or teaching. Compensation includes but is not limited to: all fees, monetary rewards, or discounts received directly or indirectly.

cow -- the female of a bovine animal.

cull cow -- a female dairy animal which is no longer profitable as a milk producing cow.

dairy bull -- a male dairy animal which has been used in the dairy herd for breeding.

DEA -- Drug Enforcement Agency

diagnosis -- the commonly accepted term used to describe a disease or injury.

diagnostic imaging services -- provide access to imaging tests (such as magnetic resonance imaging). They operate in-hospital, freestanding, and mobile imaging centers.

dispense -- to give out medicine.

D.V.M. -- Doctor of Veterinary Medicine.

D.V.S. -- Doctor of Veterinary Science.

Dx -- diagnosis.

E.R. -- emergency room.

eartag -- an APHIS approved identification conforming to the nine-character alphanumeric National Uniform Eartagging System which provides unique identification for each animal within a herd.

equine -- horse.

ewes -- female sheep that are part of the breeding herd for raising lambs.

FDA -- Food and Drug Administration

Federal/State Animal Health Technician -- an individual who vaccinates heifers at the auction barn for Brucellosis and also tests all adult cattle for this disease.

feeder pig (porker) -- weaned pig, being fattened for market.

fee for services -- A method of charging clients for services or treatment in which a veterinarian bills for each patient encounter or treatment or service rendered.

fee schedule -- a list of established charges or allowances for specified schedule medical procedures.

field test chart -- a document showing that a Brucellosis test was performed at a farmer's pasture.

filly -- young female horse.

gelding -- a male horse which has been castrated.

gilt -- a young female hog that has not produced a litter of pigs.

group -- a combined practice of three or more veterinarians who share office space, equipment, records, office personnel, expenses, or income.

guernsey -- a breed of dairy cattle that produces a rich, yellowish milk.

heifer -- a young cow that has not had a calf.

herd -- all animals under common ownership or supervision that are grouped on one or more parts of any single lot, farm, or ranch.

herd blood test -- in general, a blood test that is conducted on a herd of cattle at a farmer's pasture to test for Brucellosis.

hereford -- a breed of beef cattle which are red with white faces.

holstein -- a breed of dairy cattle that produces large quantities of relatively low fat milk.

hospital -- an institution primarily engaged on a continuous basis in providing, by or under the supervision of veterinarians, to inpatients: diagnostic and therapeutic services for medical diagnosis, treatment, and care of injured, disabled, or sick animals, and/or rehabilitation services of injured, disabled, or sick animals.

Hx -- history.

in vitro -- in the test tube; referring to chemical reactions in a laboratory situation.

jersey -- a smaller breed of dairy cattle that produces a rich milk.

kennel -- a building, a room, or small shelter for housing dogs.

L.A. -- large animal.

lamb -- a young sheep.

large animal -- a general term to distinguish one field of veterinary medicine. Large animals include horses, cattle, sheep, pigs, and goats.

malpractice -- the failure, in providing medical services, to exercise the degree of skill and care generally exercised by like professionals under similar circumstances. This term is usually applied to such conduct by doctors, lawyers, and accountants. However, it also applies to veterinarians.

mare -- a female horse.

medical record -- the record of a patient maintained by a hospital or a veterinarian for the purpose of documenting clinical data on diagnosis, treatment, and outcome.

medical administrator -- a person who maintains records that meet the medical, administrative, legal, ethical, regulatory, and institutional requirements of an entity.

MRI -- Magnetic Resonance Imager; an expensive, high-tech medical diagnostic device which utilizes magnetic energy and radio waves to produce clear images of internal organs without X-rays. May be hospital based or free standing and is often the subject of joint ventures.

M.R.C.V.S. -- Member of the Royal College of Veterinary Surgeons, a designation for a British veterinarian.

NAVTA -- North American Veterinary Technicians Association

ointment -- salve; an externally applied medication in a semisolid base.

oocyte -- immature eggs.

OR -- operating room.

outpatient -- a patient treated in a clinic and released; not confined to the hospital.

pathologist -- a veterinarian with special training in the area of diseases, especially the changes caused by diseases in the organs and tissues.

patient -- an animal, suffering from disease or injury, that is being treated by a veterinarian.

pharmacy -- a part of a building where drugs are stored, prepared, and dispensed.

pig -- a young hog, usually less than 10 weeks old.

practice -- to actively work in the field of veterinary medicine.

practitioner -- a veterinarian or physician in practice, as opposed to researching or teaching.

prescription -- administration or prescription of any drug for physical ailment by a veterinarian.

p.t. -- patient.

P.T. -- physical therapy.

Px -- physical examination.

Radiology -- the science of radiant energy and its diagnostic and therapeutic uses in medicine.

ram -- (also called bucks) a male sheep which is part of the breeding herd for raising lambs.

RANA -- a person qualified by the Registered Animal Nursing Auxiliary of Great Britain; the equivalent of a veterinary technician in the U.S.

Rx -- medication, treatment, or prescription.

shoat -- a pig that is about 8 weeks old and has been weaned.

SOAP -- Subjective, Objective, Assessment, Plan. A form of record keeping.

sow -- a female hog which has produced a litter of pigs.

steer -- a male bovine animal castrated before sexual maturity and usually raised for beef.

surgeon -- one who treats with surgery.

swab -- a piece of cotton or gauze attached to a stick used for cleaning body cavities or applying medication.

technician -- veterinary technician.

technology -- the knowledge of methods and procedures of science and medicine.

test -- a procedure performed to identify disease-causing or disease-related organisms, chemicals etc., in a body tissue such as blood or serum.

therapeutic -- pertaining to the treatment of disease, often used to mean beneficial.

therapeutics -- an area of medicine concerned with treating disease.

therapy -- the treatment of a disease:

behavior therapy -- the use of psychological methods to train animals.

physical therapy -- the use of equipment and exercise to strengthen injured muscles and limbs.

transfusion -- the transfer of blood from one animal to another of the same species.

transplant -- to transfer tissue from one location to another or from one animal to another.

treatment -- therapy.

Tx -- treatment.

vaccinate -- to administer vaccine.

vaccine -- a solution derived from bacteria or viruses to protect patients against a specific disease.

veterinarian -- one who is trained and licensed to treat and prevent disease in wild or domestic animals and to deal with problems of breeding, feeding, and housing livestock. A veterinarian will have a D.V.M., V.M.D., or M.R.C.V.S. degree.

veterinary -- pertaining to the medical care of animals.

veterinary technician -- one who is trained to assist veterinarians in most aspects of clinical veterinary work.

virology -- the study of viruses and disease caused by viruses.

V.M.D. -- Veterinary Medical Doctor.

V.T. -- Veterinary technician.

yearling -- a bovine animal that is or is rated as a year old.