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## Internal Revenue Service

# Veterinary

## Audit Technique Guide (ATG)

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

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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 *U.S. Government Printing Office Style Manual*.



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**Internal Revenue Service**

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# Veterinary Audit Technique Guide

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## **Foreword**

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

## Chapter 1: Description of the Practice of Veterinary Medicine

### Industry Background 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 2004, there were 28 colleges of veterinary medicine in the United States graduating approximately 2,200 new veterinarians each year.

### Demographics of Veterinarians

As of December 31, 2003, the American Veterinary Medical Association (AVMA) officially had 70,254 members. This represents 86% of US veterinarians.

The membership of the AVMA is further broken down by the following categories:

1,784	Large Animal exclusively (Horse, Cattle, Sheep, Goats, Swine, etc.)
33,658	Small Animal exclusively (Dogs, Cats and other pets)
3,519	Mixed Practice Predominately Large Animal (80% Large/20% Small Animal)
5,855	Mixed Practice Predominately Small Animal (80% Small/20% Large Animal)
827	Bovine Practice exclusive
2,529	Equine Practice exclusive
48,172	Total AVMA members

These 48,172 AVMA members, or 69% of the total membership, provide direct service to animals in a practice setting. The remainder 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 involves two veterinarians. AVMA statistics for 2001 indicate that there are 21,044 private veterinary practices in the United States providing medical care and professional services to animals on behalf of their owners. See JAVMA, Vol. 222, No.12, June 15, 2003.

## **Education**

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

The minimum of seven years education has escalated in cost dramatically in recent years. In addition, many veterinarians have four or more years of college education prior to acceptance in the highly competitive programs leading to a Doctor of Veterinary Medicine degree. The average educational debt of recent graduates (2003) is approximately \$70,000. The mean educational debt for 2003 graduates is over \$76,000. It is not uncommon for veterinarians to owe well over \$100,000. This debt often requires payment over ten to twenty years.

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.

Veterinarians may see their patients in a veterinary hospital or they may care for their patients on farms, ranches, feedlots, or other facilities. Both large and small animal practitioners may operate solely from self-contained mobile units, which are designed for providing services at farms or private homes. 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, or rent it from a related or non-related entity.

Veterinarians 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. Similarly, veterinarians engaged in small animal practice must maintain the particular drugs, drug dosages and biologicals, which are not available in commercial pharmacies. Mixed animal practitioners maintain drugs for both large and small animals. The need to maintain drug inventories that are necessary for the wide array of animals, which may not be treated with standard human preparations, requires the veterinarian to engage in the commercial sale of animal drugs.

Many veterinary practices derive significant income from nonprofessional services, which include the bathing, grooming and boarding of pets. These activities usually occur on the same premises where veterinary medicine and surgery are performed. Nonprofessional staff employed by the veterinarian typically performs these services. During the holidays and summer vacation season, a significant amount of time will be spent on the nonprofessional activities of boarding animals.

In addition, the sale of pet and other animal feed and non-medical supplies that animal owners frequently request are common sources of income for veterinarians. In contrast to pet shops or feed stores, veterinarians often do not use displays, posters, banners or other obvious forms of advertising on their premises despite significant sales of such products.

Physicians treating humans usually derive all of their income from activities and time devoted to providing professional services. In contrast and because veterinarians maintain unique facilities, they often devote a significant amount of time to and derive significant income from nonprofessional activities such as boarding, grooming, and the sale of drugs and biologicals.

Keep in mind that many veterinarians do not own practices, but are employed by practice-owning veterinarians. Also, there are several corporations which own a national "chain" of animal hospitals and employ a large number of veterinarians. In addition, a number of veterinarians are engaged in "relief" practice where they serve as temporary staff to other veterinarians who are required to be absent (e.g. on vacation).

A significant number of veterinarians are engaged in nontraditional practice. AVMA statistics indicate almost 9,000 veterinarians are engaged in public or corporate practice. This would include those employed by industry, universities, federal and state government and the uniformed services. These individuals



usually are not small business owners, unlike those veterinarians who own private practices.

## **Definition**

The industry includes all individuals or entities 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 sole proprietors, 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**

The types of animals treated can also differentiate veterinary practices. This section discusses three major categories:

- Large Animal (exclusive and predominant)
- Small Animal
- Mixed Animal

### *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. Many large animal practices have some type of in-house surgery or facility for treating animals on the veterinarian's premises when necessary. These in-house facilities will vary from the very simple (for example, a couple of stalls) to the state of the art specially constructed surgeries, which have been designed and equipped to accommodate the physiology of the animal being treated.

Large animal veterinary care provided at the client's premises might 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.

When 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 active and ongoing accounts receivable. The particulars regarding 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 business, veterinarians may offer different fee structures to their customers. High-volume clients may be charged less for medications and drugs than the occasional client. 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 the veterinarian accounts for personal use items.

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.)

### *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 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 be diminished. A recent trend in small animal practices has been to combine several small animal practices under 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 inventory is kept on-hand.

### *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 at Exhibit 1-1. 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**

Refer to Exhibit 4-5 for a selected list of industry organizations and their web links.

## **Income of U.S. Veterinarians**

*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 expenses and another issue devoted to revenues. 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 4-5.

## **Exhibit 1-1**

### **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 that 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. § 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.

Client -- the preferred term (rather than customer) for referring to the owners of animals who seek the services of veterinarians.

Clinic -- where patients are examined and treated.

Clinician -- a veterinarian engaged in clinical practice, as distinguished from a veterinarian engaged 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 (or biological processes) 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 professional 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 research 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 buck) 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 (or a body fluid).

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.

## **Table of Contents / Chapter 2**

## Chapter 2: Industry Issues

### Entity, Tax Year, and Accounting Method

#### I. Entity Overview

Veterinarians provide their services through sole proprietorships, partnerships, corporations, and limited liability companies. Each entity is subject to unique tax issues, corporations in particular, as described below.

##### A. *Personal Service Corporations*

Rev. Rul. 91-30, 1991-1 C.B. 61, as modified by Rev. Rul. 92-65, 1992-2 C.B. 94, holds that a corporation whose employees perform veterinary services is a qualified personal service corporation (QPSC) under Internal Revenue Code (IRC) §§ 448(d)(2) and 11(b)(2) and a personal service corporation (PSC) under IRC § 441(i)(2).

*The following tax issues arise from being a personal service corporation and/or a qualified personal service corporation:*

- 35 percent corporate rate. Unlike other C corporations, which are subject to graduated income tax rates beginning at 15 percent, a QPSC is taxed at a flat tax rate of 35 percent. See IRC §§ 11(b)(1) and (2).
- Calendar year is required unless permission is granted. Unlike other C corporations, which can adopt a fiscal tax year, a PSC is required to adopt a calendar year unless it can show a valid business purpose. See IRC §§ 441(i)(1) and (2).
- Passive Activity Losses are limited. Unlike many C corporations, which can deduct passive losses against their active income, a PSC cannot offset passive losses against its active income. See IRC § 469(e)(2).
- Accumulated Earnings Tax. A PSC may be subject to accumulated earnings tax if the accumulated earnings and profits exceed \$150,000. See IRC §§ 532 and 535(c)(2)(B). The accumulated earnings tax is equal to 15% of the accumulated taxable income, effective for tax years beginning after December 31, 2002.
- Reallocation of income. The IRS can reallocate income and tax attributes to the employee-owners if it determines that the principal purpose for forming the personal service corporation was the avoidance or evasion of

taxes. See IRC § 269A(a). This provision applies to a PSC only when substantially all of the services of the corporation are performed for (or on behalf of) one other corporation, partnership, or other entity. See IRC § 269A(a)(1).

*Note: IRC § 269A applies when a physician who is an employee of a single hospital, for example, forms a PSC through which to provide services only to that hospital. The statute does not apply to the most common kind of PSC, which is formed in order to provide services to a large number of patients or clients.*

**B. Personal Service Corporation and Qualified Personal Service Corporations, explained:**

- *Personal Service Corporation (PSC):* The tax law does not provide one sole definition of a PSC. Under IRC § 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.
- *Qualified Personal Service Corporation (QPSC):* To be a QPSC, a corporation must satisfy both a function test and an ownership test as outlined in IRC § 448(d)(2), Temp. Treas. Reg. § 1.448 1T(e)(4), and Temp. Treas. Reg. § 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 § 448(d)(2)(A) and Temp. Treas. Reg. § 1.448 1T(e)(4).

The examiner should also consider in this determination that a veterinarian may perform activities that are not health service related such as the routine boarding of animals and the sale of pet foods. (See Chapter 1-Description of the Practice of Veterinary Medicine.)

*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 § 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 § 448(d)(2)(B) and Temp. Treas. Reg. § 1.448-1T(e)(5).

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

Refer also to Exhibit 2-1, which includes a letter from the IRS to the American Veterinary Medical Association addressing the taxation of veterinary practices as QPSCs.

## **II. How to Request a Change in Tax Year under Revenue Procedure 2002-38**

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

### **A. *IRC § 444 Election***

Certain restrictions apply to the IRC § 444 election. A partnership, S corporation, or personal service corporation can elect under IRC § 444 to use a tax year other than its required tax year, but only if the deferral period of the taxable year elected is not longer than the shorter of 3 months or the deferral period of the taxable year being changed.

A partnership and an S corporation with an IRC § 444 election must make required payments under IRC § 7519 that approximate the amount of deferral benefit and a PSC with an IRC § 444 election is subject to the minimum distribution requirements of IRC § 280H. See *Required payment for partnership or S corporation* in Publication 538 and Rev. Proc. 2002-38, 2002-1 C.B. 1037, as modified by Rev. Proc. 2003-79, 2003-2 C.B. 1036.

- *Making the Election*  
Form 8716, Election to Have a Tax Year Other Than a Required Tax Year, is filed by the PSC (as defined in IRC § 441(i)(2)) to elect under IRC § 444 to have a tax year other than a required tax year. The general rules for making an IRC § 444 election are discussed in Publication 538, Accounting Periods and Methods.

**B. *Obtaining Automatic Approval***

Rev. Proc. 2002-38, 2002-1 C.B. 1037, outlines the process by which a partnership, an S corporation, an electing S corporation, or a personal service corporation can obtain automatic approval to change its tax year. In general, automatic approval can be obtained for the following business purposes:

1. To change to a required tax year or to a 52-53-week tax year ending with reference to such required tax year.
2. To retain or change to a natural business year that meets the 25-percent gross receipts test or to a 52-53-week tax year ending with reference to such natural tax year.
3. An S corporation or corporation electing to be an S corporation can get automatic approval to adopt, change to, or retain its ownership tax year or a 52-53-week tax year ending with reference to such ownership tax year.

Treas. Reg. § 1.442-1(b) provides that in order to secure the approval of the Commissioner to adopt, change, or retain an annual accounting period, a taxpayer must file an application, generally on Form 1128, Application to Adopt, Change, or Retain a Tax Year, with the Commissioner within such time and in such manner as is provided in the administrative procedures published by the Commissioner.

In general, an adoption, change, or retention in annual accounting period will be approved where the taxpayer establishes a business purpose for the requested annual accounting period and agrees to the Commissioner's prescribed terms, conditions, and adjustments for effecting the adoption, change, or retention.

### **III. Method of Accounting**

If the taxpayer is using a cash or hybrid method of accounting, an examiner should 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.

A. *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.

IRC § 448 requires all C corporations, in general, to use an accrual method of accounting for the first taxable year beginning after December 31, 1986. Note that IRC § 448(b)(2) provides an exception for qualified personal service corporations (QPSC). If a corporation is a QPSC, it is allowed to use the cash method of accounting.

Under IRC § 448(a), a partnership with a C corporation as a partner generally is required to use an accrual method, and a tax shelter must use an accrual method.

Under IRC § 448(b)(3), a C corporation or a partnership with a C corporation partner may use the cash method if it meets a \$ 5 million (or less) gross receipts test. See IRC § 448(c) and Temp. Treas. Reg. §§ 1.448-1T(f)(1) and (2) for details on this exception.

*Note: A QPSC is permitted to use the cash method of accounting. If the corporation in any year fails either the function test or the ownership test,, it is no longer a QPSC; consequently, it is required to change to an accrual method of accounting. The one exception to the mandatory change is the not more than \$5,000,000 gross receipts test. See Temp. Treas. Reg. § 1.448-1T(f)(2).*

Finally, a taxpayer chooses an accounting method when the first tax return is filed. Afterward, permission must be received from the Commissioner of Internal Revenue in order to change it. See "Changes in Accounting Methods," later.

There are three main methods of accounting that may be used by veterinarians: the cash method, an accrual method, and a hybrid method.

o *Cash Method*

Most sole proprietors, PSCs and partnerships with no inventories use the cash method of accounting. However, if inventories are necessary in accounting for income, then the accrual method for sales and purchases is required under IRC § 471, with certain exceptions, discussed in the next section. 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.

- *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 occur 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 of IRC §§ 461(a) and 461(h) are met. The purpose of an accrual method of accounting is to match income and expenses in the correct year.

***Relief from the Accrual Method - Small Businesses Exceptions:***

Under Rev. Proc. 2001-10, 2001-1 C.B. 272, certain businesses required to use inventories and account for purchases under the accrual method may use the cash method if the average annual gross receipts are \$ 1 million or less. Inventory amounts under this exception are treated as non-incidental materials and supplies under the rules of Treas. Reg. § 1.162-3.

Further, Rev. Proc. 2002-28, 2002-1 C.B. 815, expanding upon Rev. Proc. 2001-10, allows certain qualifying small business taxpayers (as defined in Rev. Proc. 2002-28 section 5) with average annual gross receipts of \$ 10 million or less to be exempted from the requirement to use the accrual method of accounting under IRC § 446 and to account for inventories under IRC § 471. According to Rev. Proc. 2002-28, inventory items are accounted for as materials and supplies under Treas. Reg. § 1.162-3. Eligible businesses include those taxpayers whose principal business is the provision of services and includes veterinary businesses.

- *Hybrid Method*

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

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.

If the cash method for reporting expenses is used, then the cash method for computing income must also be used. 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. § 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.

*B. Is Merchandise an Element in the Taxpayer's Business and Is It Income Producing?*

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, 354-55 (1st Cir. 1970), the court, after canvassing authorities in the accounting field for definitions of the term, found that the common denominator among the various definitions was that an item is merchandise if held for sale. Based on the regulations and the case law, the Service has determined that, for purposes of Treas. Reg. § 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 cash 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*. See, e.g., *Wilkinson-Beane, Inc. v. Commissioner*, 420 F.2d at 355.

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

1. *Analyze purchases*. 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 and such items are accounted for as materials and supplies under Treas. Reg. § 1.162-3. Some examples of supplies are: alcohol, whippets, combs, tongue depressors, disposable syringes, rubber gloves, and like items. These can be accounted for as materials and supplies under Treas. Reg. § 1.162-3.

In addition, certain court cases have held that the furnishing of pharmaceuticals by a medical treatment facility was so integrated in the rendering of the medical service that such drugs did not have to be inventoried. See *Osteopathic Medical Oncology and Hematology, P.C. v. Commissioner*, 113 T.C. 376 (1999), acq. in result, 2000-23 I.R.B. 2, and *Mid-Del Therapeutic Center, Inc. v. Commissioner*, T.C. Memo. 2000-130, aff'd, 89 A.F.T.R.2d 2002-1106, 2002-1 USTC 50,245.

However, if the same medical supplies or drugs listed above are sold separately to the veterinarian's customers, they may constitute inventory.

2. *Compare purchases with gross receipts*. 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 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 unusual circumstances exist, then use the current value as both beginning and ending inventory value. In this example, your adjustment would be to increase income by the amount of the opening inventory amount under IRC § 481(a). (See Accounting Method discussion, below).

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 after considering all revenue procedures (discussed above) which provide relief from using the accrual method.

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.

### C. *Handling Changes of Accounting Methods*

Examiners can refer any issue dealing with accounting method changes to the Accounting Method Changes Technical Advisors in the Large and Midsize Business Division (LMSB).

The examiner has the authority to change a taxpayer's method of accounting when no method has been used regularly or when the method used does not clearly reflect income. IRC § 446(b). The examiner also has the authority to select a proper method, and the selection may only be challenged by showing there was an abuse of discretion. See *Wilkinson-Beane, Inc. v. Commissioner*, T.C. Memo. 1969-79.

Examples of method change issues that may be raised during an examination include:

- Changing from cash to accrual method as required by IRC § 448.
- Expensing items required to be capitalized under IRC § 263 or § 263A.
- Changing the timing of accrual under IRC § 451 or IRC § 461.

In general, voluntary changes are initiated by the taxpayer by filing a Form 3115, Application for Change in Accounting Method, referring to the directions therein.

Involuntary changes (i.e. those proposed by Examiners) are covered by Revenue Procedure 2002-18, 2002-1 C.B. 678, which provides guidance to examiners initiating accounting method changes. Section 2.03 of the procedure states that the “taxpayer does not have a right to a retroactive change, regardless of whether the change is from a permissible or impermissible method.” Accordingly, the examiner is not obligated to consent to a retroactive change in accounting method requested by the taxpayer either by a formal or informal claim. However, if the examiner initiates a change in accounting method issue that, upon development, results in a taxpayer favorable result, the examiner should follow through using the Service initiated change procedures.

## **IV. Balance Sheet Issues**

Typical balance sheet audit issues and techniques are found at IRM 4.10.3.8, in addition to the exam techniques found at IRM 4.10.3.6 for Schedules M-1 and M-2. Following are industry specific issues that examiners could encounter.

### *A. Intangibles*

#### *1. Customer/Medical records*

Customer/medical records usually include the veterinary history, a record of visitations, treatments performed by the veterinary 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 § 162.

Customarily when a veterinary practice is sold, a value is assigned to the customer/medical records and the purchasing party, for book purposes, will either depreciate or amortize the records over a period of time (which may be straight line for 60 months). However, for tax purposes, customer/medical records are intangibles within the meaning of IRC § 197 and are subject to the 15-year amortization rules (see Publication 535 chapter 9).

#### *2. Purchase of a veterinary practice*

An issue that may be present is the overvaluation of tangible assets and the undervaluation of intangible assets, which accelerates the purchaser'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 §§ 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 § 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 § 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.

## V. **Income Issues**

### *Customers pay in cash*

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 small animal and mixed animal customers may pay for their services in cash.

Audit experience indicates that 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 receipts journals segmented by day, week or month; customer ledger cards detailing individual charges; payments and adjustments; or accounts receivable lists. However 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 who have been found to rely on bank deposits to reconcile gross receipts (which in most cases understates income) indicated that they were unaware of the computerized record keeping systems. These preparers provide only year-end compilation rather than complete income analysis of services rendered by the veterinary practice. They have indicated that when 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 confidently 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.

Based on this discussion, business income can easily be diverted from being deposited into the business bank account(s) and reported on the tax return. Therefore, it is imperative that each examination includes alternative methods of determining gross receipts. The use of patient billing records, accounts receivable ledgers, and patient sign in registers are examples of other sources.

*Note: The IRM provides guidelines for expanding the scope of examinations to include the veterinarian's personal bank accounts and the evaluation of the veterinarian's financial status.*

#### A. Gross Receipts

1. Analyze the duplicate deposit slips. In general, 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. Select a sample and trace the entries on the customer account ledger cards to the day sheets.

4. Analyze the charge slips. It is possible to pull the customer account ledger cards that one 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 the veterinary practice*

Many issues can arise from the sale of a medical practice. Among them is how to handle the outstanding accounts receivables. The contract for sale must be secured and inspected in order to consider the various issues (including proper income recognition) that may be present.

2. *Passive income recharacterization*

- a. Per IRC § 469(a)(2)(C), a PSC *is subject to the passive activity loss rules.*
- b. *Self Rented Real Estate* – It is a common practice for a veterinarian to own the building personally (or sometimes in partnership) and to lease it to the PSC. In this scenario, the net rental income is recharacterized as nonpassive income under Treas. Reg. § 1.469-2(f)(6) and should not be reflected on Form 8582, Passive Activity Loss Limitations, line 1a, where it would improperly trigger otherwise nondeductible passive losses.

Does the taxpayer materially participate in the entity renting from the taxpayer? The answer is almost always yes.

*If the answer is “yes”, the rental income should be treated as nonpassive and should not be reflected on Form 8582.*

*Considerations:*

- Is rent at a fair market value?
  - Is there any personal use of the building space?
- c. *Self Rented Equipment:* Net losses are generally passive under IRC § 469 (c)(2) and (4) whether or not the taxpayer materially participates. Thus, losses are not deductible in the

absence of passive income. Net income is nonpassive under Treas. Reg. § 1.469-2(f)(6).

*Other Considerations:*

- Is rent at a fair market value?
- Is there any personal use?

Reminder: Bare equipment leases are subject to self employment tax. IRC § 1402(a)(1) excepts real estate, but not bare equipment leases. Also, see *Stevenson v. Commissioner*, T.C. Memo. 1989 357.

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 that should be recharacterized from portfolio income to passive income per Treas. Reg. § 1.469-7(a)(1)(i) and (c). This rule is generally beneficial to the taxpayer. However, the interest income that is recharacterized as passive cannot be used as investment income on Form 4952, *Investment Interest Expense Deduction*. Thus, there may be an adjustment to allowable investment interest expense. Investment interest is deductible only to the extent of investment income under IRC § 163(d).

## VI. Expense Issues

IRM 4.10.3.10 provides general guidelines in the audit of Cost of Goods Sold expenses while IRM 4.10.3.11 provides audit technique guidelines in the audit of operating expenses.

In addition to considering the typical large and unusual expense items in an audit, below are certain expense issues encountered in a veterinary audit.

A. *Lease versus Purchase*

In a veterinary practice, many assets can be leased rather than purchased, including tables, chairs, desks, and x ray equipment. Many lease agreements have an option to purchase the assets at the end of the lease term for a nominal price. 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 Co. v. U.S.*, 446 F.2d 269 (10th Cir. 1971); Rev. Rul. 55 540, 1955 2 C.B. 39.

Factors in Rev. Rul. 55 540 that 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 § 446 apply. Further, the provisions of IRC § 481 generally apply when such a change is made by the examiner as part of an examination.

#### *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 § 280A(c)(1)(A). See Rev. Rul. 99 7, 1999 1 C.B. 361.

#### *C. Entertainment, Travel, and Meals*

IRC § 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.

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

## **VII. Constructive Dividends (C Corporations)**

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 dividends 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.

*Note: Remember that a corporate distribution is a dividend only to the extent of earnings and profits.*

### **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.

### **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 headings 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.

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. See Treas. Reg. § 1.301-1(j). In the case where the distributed property (in a bargain

purchase by the shareholder) is “appreciated property” (the corporate property’s fair market value exceeds its adjusted tax basis), gain is also recognized at the corporate level. See IRC § 311(b).

## **VIII. Section 1374 Built-in Gains**

### *A. Tax on Built In Gains - IRC § 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 recognized for tax purposes until the payments are received. Under IRC § 1374, when 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 the 10-year period beginning with the first day of the first taxable year for which the corporation was an S corporation or the day on which the S corporation acquires assets from a C corporation 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 § 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 § 39, the carryforward amount will be allowed as a credit against the tax.

### *B. Whipsaw Issue*

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

## **IX. Accumulated Earnings Tax -- IRC § 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.

## **X. 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 an IRC § 444 fiscal year. These 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, distribution of the receivables would trigger an IRC § 336 gain on liquidation to the extent of the fair market value of 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. 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 (1992). Also consider *Treas. Reg. § 1.263(a)-4*, which details rules on capitalization or expensing of amounts paid or incurred for certain intangible assets on or after December 31, 2003.*

## **XI. S Corporation Issue: 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. Therefore, the issue of inadequate compensation to a shareholder/officer in an S corporation examination may be an issue, resulting in an employment tax case. See *Veterinary Surgical Consultants, P.C. v. Commissioner*, 117 T.C. 141 (2001).

To evaluate the income of US veterinarians, see JAVMA, Vol. 222, No.12, June 15, 2003, for the Veterinarian Industry Compensation rates, which provide information related to the industry compensation rates. Remember that this survey is only a guide, not an absolute standard, and may have later updates.

## **Exhibit 2-1**

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January 1, 2001 (Volume 218, No. 1)

### ***Small Business Concerns***

#### *Clarification of C-corporation classification of veterinary corporations*

During the 2000 Annual Session of the AVMA House of Delegates, the Council on Veterinary Service and the California Veterinary Medical Association submitted a resolution requesting that the AVMA pursue a Technical Advice Memorandum (TAM) from the Internal Revenue Service. The intended purpose of the desired TAM was to allow veterinary corporations with more than 5% of their gross income from non-professional sales to be classified as regular C corporations for income tax purposes, rather than as qualified personal service corporations (QPSC). Currently, veterinary C corporations that meet certain ownership and function tests are required to file as QPSC. Qualified personal service corporations are taxed at a flat rate of 35% of taxable income, whereas regular C corporations are taxed at a graduated rate beginning at 15% and increasing to 35%.

Following extensive discussion and recognizing technical problems in the language of the proposed resolution, the House of Delegates referred the issue to the AVMA Executive Board. The Executive Board referred the matter to the Legislative Advisory Committee (LAC) for consideration.

In preparation for the October meeting of the LAC, AVMA staff and officers met twice with IRS personnel. During the second of these meetings, IRS personnel delivered a letter (see pp 23-24) to the AVMA that they believed would address the veterinary profession's concerns. The language of the underlying regulations does not allow the IRS to accept the premise that the percentage of income from non-professional sales and services can be used as an accurate reflection of the percentage of time spent in non-professional activities. However, the letter did clarify some of the criteria that affect the ownership and function tests used to determine whether a veterinary corporation is classified as a QPSC.

With regard to the ownership test, if more than 5% of a corporation's stock is owned by a spouse, family member, or another individual who is not employed by the corporation, the corporation fails the ownership test and is not a QPSC. However, further clarification of the ownership test may be

needed for corporations in community property states.

With regard to the function test, if more than 5% of the time spent by the corporation's employees is spent in activities that are not directly involved in the performance of professional services or the performance of activities incidental to those services (such as supervision of employees providing services, completion of administrative duties, and provision of support services), the corporation fails the function test and is not a QPSC. In this regard, the IRS does not consider boarding and grooming of healthy animals, retail sale of pet food and pet products, and dispensing of prescription or over-the-counter pharmaceuticals to be a necessary part of the performance of veterinary services, and time spent by the corporation's employees in such activities is considered time that is not directly involved in the performance of professional services. For example, the IRS representative stated that because prescription drugs can be obtained from pharmacies and other sources, sales of these products are not considered necessary to the practice of veterinary medicine.

It is important to remember, however, that the function test is based on time spent in qualifying (activities directly involving the performance of services) versus non-qualifying (activities not directly related or necessary to the performance of services) activities, and not to the relative income from them. To verify what percentage of time is spent by the corporation's employees in performing qualifying activities and what percentage is spent performing non-qualifying activities, some contemporaneous record of how time is spent is required. However, IRS personnel have emphasized that this record-keeping need not be onerous, and the IRS is willing to consider any reasonable method.

During the meetings with IRS personnel, additional written questions were submitted, and AVMA staff anticipates further correspondence from the IRS with responses to those questions. In the meantime, the IRS has stated that its letter to the AVMA can be cited as an official source document. Veterinarians should consider this important new information carefully and share it with their tax consultants as they plan their tax strategies.—Dean E. Goeldner, DVM, Assistant Director, AVMA Governmental Relations Division (© 2000-2004 American Veterinary Medical Association. All rights reserved)

**September 27, 2000**

American Veterinary Medical Association  
1101 Vermont Avenue, NW, Suite 710  
Washington, DC 20005-3521

Dear Doctors,



This letter is written in response to your request for reconsideration, or possible revocation, of Revenue Ruling 91-30, which designates veterinarians as personal service providers. The request was prompted by the settlement of an income tax case in which a veterinarian established that his corporation was not a qualified personal service corporation (QPSC) and, therefore, was not subject to the 35% tax rate under Internal Revenue Code 11(b). We appreciate your bringing this case to our attention and your concern for the equitable and consistent treatment of taxpayers within the veterinarian profession. My research of tax returns filed by veterinarians during 1999 indicates that this issue may possibly affect approximately 12% of the population, which file corporate returns. (20% file as S-corporations, 5% file as partnerships, and 63% file as sole proprietorships.)

Generally, under Code section 448, corporations cannot use the cash method of accounting to compute taxable income. However, there is an exception allowing corporations providing personal services to use the cash method if specific conditions are met.

First, the personal services must be in one of eight professions, including the fields of health, law, engineering, architecture, accounting, actuarial science, the performing arts, and consulting. By virtue of Revenue Ruling 91-30, veterinarians are members of the healthcare profession.

Second, there is an ownership test. Substantially all (95%) of the corporation's stock must be owned by the employees providing the services for the corporation. Collectively, "employees" include current employees, retired employees, estates of employees, and individuals who acquired stock by reason of death of an employee.

Finally, there is a function test. Substantially all (95%) of the corporation's activities must involve the performance of services. This means that 95% of the time spent by employees of the corporation is devoted to the actual performance or supervision of the qualifying services, administrative duties or support. In the veterinarian's case, he appealed the examiner's findings and presented his argument to an Appeals Officer, who has authority to arbitrate the issue. The appeal process is informal and is intended to alleviate the burden of presenting the case before Tax Court. He convincingly argued that specific services and the retail sale of pet products were non-service business activities and were not incidental to the performance of veterinary healthcare services and (2) that annual gross revenue was the most accurate measure of time spent by the corporation's employees.

The veterinarian's settlement is specific to his case and cannot be used as a basis for determining tax policy. We can, however, reconsider each of the three criteria used to define qualified personal services as they are applied to veterinarians.

## I. Designated Profession

Revenue Ruling 91-30, specifically includes veterinarians as members of the healthcare profession. In fact, the first paragraph of the current audit technique guide starts with the statement that doctors of veterinary medicine are medical professionals, whose primary responsibility is protecting the health and welfare of animals and people. It would be difficult to support the reversal of Revenue Ruling 91-30.

However, another aspect of IRC 448 needs to be considered. This Code section was enacted to limit the use of the cash method of accounting by corporations, but qualified personal service corporations are excepted from this restriction under IRC 448(b)(2). If veterinarian practices lose their status as qualified personal service corporations, it may be necessary for them to use the accrual method of accounting for all their activities; i.e., hybrid cash and accrual methods may not be allowable. Alternatively, Rev. Proc. 2000-22 provides that qualifying taxpayers with average annual gross receipts of \$1,000,000 or less are excepted from the requirement to use an accrual method of accounting. This determination is made each year and, if the taxpayer ceases to qualify for the exception, they must change to an inventory method.

## II. Ownership Test

95% of the corporation's stock must be owned by the employees providing the services for the corporation. As stated earlier, "employees" include current employees, retired employees, estates of employees, and individuals who acquired stock by reason of death of an employee. A corporation's stock is considered held "indirectly" by a person if, and to the extent that, such person owns an interest in a partnership, "S" Corporation, or another qualified personal service corporation, that owns stocks in the corporation. However, other forms of indirect stock ownership, such as familiar attributions, are not considered. Therefore, non-employee spouses, parents or children of an owner-employee could own more than 5% of the corporate stock and the corporation would fail the ownership test. (See Regulation 1.448-1T (e) (5) (vii), Example 6.)

## III. Function Test

95% of the corporation's activities must involve the performance of services. This means that 95% of the time spent by all the employees of the corporation is devoted to the actual performance of the qualifying services and any incidental activities such as supervising employees who are providing the services, administrative duties, and support services. Non-qualifying activities include (but are not limited to) the retail sale of pet

supplies or medications, and the boarding or grooming of animals not under the veterinarian's medical care. Therefore, if more than 5% of the time spent by all employees is dedicated to non-qualifying activities, the corporation is not a qualified personal service corporation.

#### Alternative Solution

If an incorporated veterinarian practice does meet the stock ownership and function tests, the impact of higher tax rates for qualified personal service corporations can be limited by paying out reasonable wages to the employee. The corporation's taxable income will be reduced and the income will be shifted to personal returns subject to graduated tax rate. While this is an acceptable practice, a cautionary note must be emphasized. When the corporation's taxable income is reduced by paying out wages, there may be an issue of excessive compensation. (See audit technique guide, pages 4-22 through 4-28.) It will also be necessary to carefully consider dividend distributions.

#### Conclusion

It appears that there are alternatives for veterinarians filing corporate returns to address issues regarding their designation as qualified personal service corporations. However, only the corporate officers can decide what is best for them individually and I would recommend that they consult with a tax professional before making any decisions.

We hope this information will be of assistance to you. If you have any questions, please feel free to call xxxxx xxxxxxxxx, of my staff, at xxx-xxx-xxxx.

Sincerely,

xxxxxxx x. xxxxxx

Manager, Market Segment Strategies

Editor's note: xx. xxxxxxxxx can also be reached by e-mail at xxxxx.x.xxxxxxxx@irs.gov

## Chapter 3: Examination Techniques

### I. 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 structure (e.g., closely held) and the size of the entity.

Auditing a small to medium size veterinary corporate 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 the system of internal accounting controls.

Many veterinary 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:

- Articles of incorporation, bylaws, and stock certificate book
- Minutes of board meetings
- Organization chart
- Chart of accounts
- Contracts and agreements, such as leases
- Description of the accounting system and internal controls
- Loan agreements and other evidences of indebtedness 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 Form 5500s

Exhibit 3-1 is a sample Form 4564, Information Document Request, to assist you in obtaining these records.

## II. Veterinary Office Procedures and Records

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 that may be appropriate. The plan is not all-inclusive and should be modified for the taxpayer under examination.

A thorough understanding of the accounting systems is particularly important in the veterinary industry. The records created (hard copy or computer) by these types of systems may provide a valuable source of information in the examination of the veterinary 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.

### A. General Procedures:

1. The first record of customer visits to a veterinarian's office is the **Appointment Book**. This will reflect the customer'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, customer 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 customer'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.

### III. 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 should be included in the interview as well. As an audit aid, Exhibit 3-3 includes a listing of specific questions that 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 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.

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 statements, 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 veterinary 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.

## **IV. Examination Techniques - Balance Sheet**

General audit techniques for analyzing a balance sheet can be found at IRM 4.10.3.8. Guidance on reconciling a taxpayer's books and records can be found at IRM 4.10.3.5.6, and IRM 4.10.3.6 details audit steps for analyzing Schedules M-1 and M-2. Industry-specific balance sheet issues are discussed below.

### **A. *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 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. Therefore, consider all accounts when analyzing the cash account.

### **B. *Accounts Receivable***

The method of reporting revenue must be determined when analyzing this account.

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

In closely held situations, inclusion of loans to related parties in receivables should be reviewed.

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



### C. *Investments*

Veterinarians often hold stocks, bonds, real estate (for example, farms), or other types of investments through their corporations. Ensure that all income reporting (including sales of investments) has taken place when analyzing this account.

### D. *Inventory*

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

Remember that inventory items frequently include medicine, drugs, and feed supplements, as well as a large variety of pet items such as carriers, shampoos, and collars. Inventory versus supplies is a major issue in many situations. Also, as discussed in Chapter 2, certain court cases have held that the furnishing of pharmaceuticals by a medical treatment facility was so integrated in the rendering of the medical service that such drugs did not have to be inventoried. See *Osteopathic Medical Oncology and Hematology, P.C. v. Commissioner*, 113 T.C. 376 (1999); *Mid-Del Therapeutic Center, Inc. v. Commissioner*, T.C. Memo. 2000-130.

Any medical supplies or drugs which are sold separately to the veterinarian's customers may still constitute inventory.

## **Exhibit 3-1**

### **Form 4564, Information Document Request**

#### ***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, that is, subsidiary, parent, and 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 for 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 Ledger.
  - b. All subsidiary ledgers.
  - c. General Journal - including payroll.
  - d. Cash Disbursements.
  - e. Cash Receipts.

- f. Voucher payables.
  - g. Sales.
  - h. Purchases.
  - i. Any other special journals maintained.
- 5. All journals, records and workpapers for the year under examination pertaining to Business Gross Receipts, including 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, and 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

## Exhibit 3-2

Taxpayer Name:

Form:

Year:

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. Scrutinize adjusting entries				
	9. Scrutinize financial statements				
	10. Compare 941's to Wages and Taxes				
	11. Scrutinize related returns, sub years				
	12. Scrutinize pension/profit sharing plan				
	12a. Complete Form 4632 and 4632-A				
	13. Scrutinize Books				
	13a. General Journal				
	13b. Sales reversals				
	13c. Comparative Statements				
	14. Refine audit plan -- select items				
	15. Complete Gross Income Probe- Consider IRM 4.10.4.				
	16. Scrutinize canceled checks				
	16a. Additional banks				
	16b. Foreign activities				
	16c. Related transactions				
	17. Special Issues - Employment Tax				
	18. Related Party Transactions IRC §§ 7872, 461, and 267(a)				

## Exhibit 3-3 (1 of 7)

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 § 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:

## Exhibit 3-3 (2 of 7)

### ***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?

Does the taxpayer 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:

## Exhibit 3-3 (3 of 7)

### 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. Has the taxpayer 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 portion 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 (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?

### Exhibit 3-3 (4 of 7)

- 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 all 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.
  
  - 19. @1 Does the taxpayer have an Internet presence? (Web site, web page, e-mail, banner for business purposes, how many websites are used by the business)
  
  - 20. @1 Does the taxpayer conduct business transactions over the Internet? (Accept orders and/or payments over the Internet?)
- @1= If answered yes, refer to <http://e-commerce.web.irs.gov/People.htm>

NOTES:



## Exhibit 3-3 (5 of 7)

### ***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 veterinary services? (Directors' fees, etc?)
8. Does the taxpayer 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?  
Deposited?

Were Forms 8300 filed? (Secure copies).

NOTES:

## Exhibit 3-3 (6 of 7)

### **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 Social Security Numbers (W 4, W 9)?  
Have they ever received a notification letter from the IRS regarding no/invalid SSN/EIN? 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 veterinary 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 veterinary school? Repayment history?

Have any amounts been expensed through the corporation?

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## **Chapter 4: Supporting Law/ Industry Organizations & Web Sites**

### **Introduction**

This chapter is designed to provide the examiner with the ability to make use of the guide by referencing a particular code section in lieu of a topic as well as providing a list of industry web sites. Relevant code sections, treasury regulations, revenue rulings, revenue procedures, and court decisions cited within the guide are outlined below.

In addition, selected industry organizations and their web sites, as well as links to other items referenced in the guide, are provided.

## Exhibit 4-1 - Cited Code Sections

Code Section	Chapter Topic	Page
IRC § 11(b)	Section 1374 Built-in gains	2-17
IRC § 11(b)(1)&(2)	35% corporate tax rate	2-1
IRC § 11(b)(2)	Personal Service Corporation (PSC)	2-1
IRC § 39	Tax on Built-in gains—IRC 1374	2-18
IRC § 162	Customer/Medical records	2-10
IRC § 163(d)	Self-charged interest	2-14
IRC § 197	Customer records	2-10
IRC § 263 & 263A	Handling Changes of Accounting Methods	2-9
IRC § 269A(a)&(a)(1)	Reallocation of income	2-1
IRC § 274(a)(3)	Entertainment, Travel, and Meals Club memberships	2-15
IRC § 274(d)	Entertainment, Travel, and Meals	2-15
IRC § 274(n)	Entertainment, Travel & Meals-50% limitation	2-15
IRC § 280A(c)(1)(A)	Automobile Expense	2-15
IRC § 280H	IRC §444 Election	2-3
IRC § 311(b)	Bargain Purchase	2-17
IRC § 441	PSC	2-2
IRC § 441(i)(1)&(2)	Calendar year is required & PSC	2-1
IRC § 444	How to request a change of tax year	2-3,2-4
IRC § 444	Conversion of a PSC to an LLC	2-18
IRC § 446	Relief from the Accrual Method	2-6
IRC § 446	Purchase of Veterinary supplies	2-10
IRC § 446	Lease versus purchase	2-15
IRC § 448	Selection of proper Accounting Methods	2-5
IRC § 448(a)(2)&(3)	Ownership test	2-2
IRC § 448(d)(2)	QPSC	2-1,2-2
IRC § 448(d)(2)(A)	Function test	2-2
IRC § 448(d)(2)(B) & (4)(C)	Ownership Test	2-3
IRC § 451 & § 461	Handling Changes of Accounting Method	2-9
IRC § 461(a) & (h)	Accrual Method	2-6
IRC § 469(a)(2)(C)	Passive income recharacterization (Personal Service Corp)	2-13
IRC § 469(c)(2) & (4)	Self-rented Equipment	2-13
IRC § 469(c)(2) & (4)	Relief from the Accrual Method	2-6

### Exhibit 4-1 - Cited Code Sections (continued)

Code Section	Chapter Topic	Page
IRC § 469(e)(2)	Passive losses are limited	2-1
IRC § 471	Cash Method	2-5
IRC § 471	Relief from the Accrual Method	2-6
IRC § 481(a)	Compare purchases with gross receipts	2-9
IRC § 531	Accumulated Earnings Tax	2-18
IRC § 535(c)(2)(B)	Accumulated Earnings Tax	2-1
IRC §1366(f)(2)	Whipsaw issue	2-18
IRC § 1374	Whipsaw issue	2-18
IRC § 1402(a)(1)	Self-rented equipment	2-13
IRC § 7872	Potential Imputed Interest	2-11

### Exhibit 4-2 - Cited Regulations

Regulation	Chapter Topic	Page
Treas. Reg. § 1.162-3	Relief from the Accrual Method	2-6
Treas. Reg. § 1.162-3	Analyze Purchases	2-8
Treas. Reg. § 1.263(a)-4	Conversion of a PSC to an LLC	2-19
Treas. Reg. § 1.301-1(j)	Bargain Purchases	2-17
Treas. Reg. § 442-1(b)	Obtaining Automatic Approval	2-4
Treas. Reg. § 1.446-1(c)(1)(iv)	Accounting Methods	2-6
Temp. Treas. Reg. § 1.448-1T(e)(4) & (5)	Qualified Personal Service Corp.	2-2, 2-3
Temp. Treas. Reg. § 1.448-1T(e)(4)	Function Test	2-2
Temp. Treas. Reg. § 1.448-1T(e)(5) & (5)(vi)	Ownership Test	2-3
Temp. Treas. Reg. § 1.448-1T(f)(1) & (2)	Method of Accounting	2-5
Treas. Reg. §1.469-2(f)(6)	Inspect the Veterinarians Form 1040	2-14
Treas. Reg. §1.469-2(f)(6)	Self-rented real estate & equipment	2-13
Treas. Reg. § 1.469-7(a)(1)(i) &(c)	Self-charged interest	2-13

### Exhibit 4-3 - Cited Revenue Rulings and Revenue Procedures

Revenue Rulings and Revenue Procedures	Chapter Topic	Page
Rev. Proc. 2001-10	Relief from the Accrual Method exception	2-6
Rev. Proc. 2002-18	Handling Changes of Accounting Methods	2-9
Rev. Proc. 2002-28	Relief from the Accrual Method exception	2-6
Rev. Proc. 2002-38	Obtaining Automatic Approval	2-4
Rev. Proc. 2002-38	IRC § 444 Election	2-3
Rev. Proc. 2003-79	Change in Tax Year	2-3
Rev. Rul. 91-30	Personal Service Corporation	2-1
Rev. Rul. 99-7	Automobile Expenses	2-15
Rev. Rul. 55-540	Lease versus purchase	2-14

### Exhibit 4-4 - Cited Court Cases

Court Case	Chapter Topic	Page
INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992)	Ordinary expenses	2-19
Lockhart Leasing Co. v. U.S., 446 F.2d 269 (10 <sup>th</sup> Cir. 1971)	Lease versus purchases	2-14
Mid-Del Therapeutic Center, Inc. v. Commissioner, T.C. Memo. 2000-130	Analyze Purchases	2-8, 3-6
Osteopathic Medical Oncology and Hematology, P.C. v. Commissioner, 113 T.C. 376 (1999)	Analyze Purchases	2-8, 3-6
Stevenson v. Commissioner, T.C. Memo. 1989-357	Self-Rented Equipment	2-13
Veterinary Surgical Consultants, P.C. v. Commissioner, 117 T.C. 141 (2001)	S Corporation Issue-Inadequate compensation	2-19
Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352 (1 <sup>st</sup> Cir. 1970)	Is Merchandise an Element in the Taxpayer's Business and Is It Income-Producing?	2-7
Wilkinson-Beane, Inc. v. Commissioner, T.C. Memo. 1969-70	Handling Changes of Accounting Method	2-9

## Exhibit 4-5 - Selected Industry Organizations and Web Sites

Industry	Web Site
1. Agricultural Research Service	<a href="http://www.ars.usda.gov">www.ars.usda.gov</a>
2. American Animal Hospital Association	<a href="http://www.healthypet.com">www.healthypet.com</a>
3. Association for Assessment and Accreditation of Laboratory Animal Care International (AAALAC International) <i>formerly the American Association for Accreditation of Laboratory Animal Care</i>	<a href="http://www.aaalac.org">www.aaalac.org</a>
4. American Society for the Prevention of Cruelty to Animals	<a href="http://www.aspca.org">www.aspca.org</a>
5. American Veterinary Medical Association	<a href="http://www.avma.org">www.avma.org</a>
6. Animal and Plant Health Inspection Service	<a href="http://www.aphis.usda.gov">www.aphis.usda.gov</a>
7. Association of American Veterinary 8. Medical Colleges	<a href="http://www.aavmc.org">www.aavmc.org</a>
9. Centers for Disease Control and Prevention	<a href="http://www.cdc.gov">www.cdc.gov</a>
10. Environmental Protection Agency	<a href="http://www.epa.gov">www.epa.gov</a>
11. Food and Drug Administration	<a href="http://www.fda.gov">www.fda.gov</a>
12. Food Safety and Inspection Service	<a href="http://www.fsis.usda.gov">www.fsis.usda.gov</a>
13. National Animal Health Monitoring System	<a href="http://www.aphis.usda.gov/vs/ceah/cahm">www.aphis.usda.gov/vs/ceah/cahm</a>
14. National Institutes of Health	<a href="http://www.nih.gov">www.nih.gov</a>
15. National Research Council	<a href="http://www.nas.edu/nrc">www.nas.edu/nrc</a>
16. National Science Foundation	<a href="http://www.nsf.gov">www.nsf.gov</a>
17. National Veterinary Services Laboratories	<a href="http://www.aphis.usda.gov/vs">www.aphis.usda.gov/vs</a>
18. North American Veterinary Technician Association	<a href="http://www.navta.net">www.navta.net</a>
19. Technology Assessment, The Congress	<a href="http://www.wws.princeton.edu/~ota">www.wws.princeton.edu/~ota</a>
20. Pan American Health Organization	<a href="http://www.paho.org">www.paho.org</a>
21. U. S. Public Health Service	<a href="http://www.usphs.gov/html/veterinarian.html">www.usphs.gov/html/veterinarian.html</a>
22. Agricultural Research Service	<a href="http://www.ars.usda.gov">www.ars.usda.gov</a>
23. American Animal Hospital Association	<a href="http://www.healthypet.com">www.healthypet.com</a>

## Exhibit 4-6 - Other Reference Web Links

Web Links	Chapter Topic	Page
IRM 4.10.3.6 , IRM 4.10.3.8	Balance Sheet Techniques	2-10, 3-4
IRM 4.10.3.10, IRM 4.10.3.11	Expense Issues	2-14
IRM 4.10.3.5.6	Techniques- Reconciling books & records to tax return	3-4
<a href="http://e-commerce.web.irs.gov/People.htm">e-commerce.web.irs.gov/People.htm</a>	Initial Interview- IRS Contacts when e-commerce present	3-13
Form 3115 & Instructions	Handling Changes of Accounting Methods	2-9
Form 8582	Self-Rented Real Estate	2-13
Form 8716	Making the Election	2-3
Publication 535	Customer/Medical Records	2-10
Publication 538	IRC § 444 Election	2-4

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