## IRS updates and expands audit technique guide for exams of consultants

Perhaps in response to the consulting industry's explosive growth, IRS has updated its Business Consultants audit technique guide (ATG). In addition to reflecting new developments, the ATG has been expanded to include a new section addressing income-shifting and substance versus form.

Following is an overview of some of the key areas agents are instructed to examine when reviewing a consultant's return.

*Pre-audit.* Examiners are instructed to determine that the taxpayer has reported all of the income required to be reported and that the income was reported in the proper period by the proper entity. Among other items, examiners are told to be alert for the following:

... the lack of internal controls;

... the types of books and records the taxpayer maintains, particularly in the area of electronic software;

... the taxpayer's use of bartering;

... the shifting or assignment of income by a taxpayer to a related entity;

... the taxpayer's use of the Internet; and

... the taxpayer's use of a fiscal year end in order to defer income.

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

Examiners are told to review the taxpayer's consulting agreements/contracts and to look for certain information. For example, auditors should look at whether the taxpayer is an S corporation or a partnership and yet the contract requires the services of a particular employee/owner. These concerns are aimed at determining whether there has been a shifting or assignment of income. The ATG discusses various cases on this subject.

The ATG also stresses that how a transaction is taxed depends upon its substance. At the same time, it notes that taxpayers are generally bound by the form in which they choose to cast their transactions.

The ATG notes that the economic substance doctrine has been codified for transactions entered into after Mar. 30, 2010.

*Tax years.* The ATG alerts auditors to the possibility that a taxpayer may have improperly selected a fiscal tax year other than a calendar year in order to defer income.

*Travel.* The ATG observes that there is extensive travel inside and outside the U.S. in the consulting field because many consultants have a specialized niche and a broad geographical client base. Auditors are told to look for spousal/family travel and personal travel, particularly out of country.

*Independent contractor vs. employee.* The ATG observes that the independent contractor versus employee issue is prevalent in the consulting industry. Potential areas of concern include a former employee coming back to a company as an independent consultant with a minimal break in service. This issue has evolved due to the downsizing taking place in the business world over the past decade. Many employers, in an effort to lower costs, have terminated specialized employees and then hired them back as independent consultants. This allows the employer to lower their costs in payroll and employee benefits.

Another potential issue may arise when a consultant obtains a client for which he does not have all the resources himself to fulfill the contract. To meet the client's needs, the consultant forms business relationships (strategic alliances) with other individuals. This can lead to an employee/employer relationship.

*Meals and entertainment.* Given the considerable travel usually required in the consulting industry, auditors are alerted that there may be sizeable expenses for meals and entertainment. Potential areas of concern noted in the ATG include the proper application of the applicable percentage limitation and the point that travel status meals and entertainment should be limited if not being reimbursed by client. Another area of concern is meals and entertainment in non-travel status.

*Personal service corporations.* Here, the ATG looks at whether a C corporation meets the definition of a qualifying personal service corporation. The concern is twofold. Some C corporations may want to be considered a personal service corporation in order to be able to use the cash method of accounting. Others may not want to be considered a personal service corporation in order to take advantage of the graduated tax rates.