Audits of Gasoline Service Stations

If you are in certain retail businesses, industry specific audit procedures may be performed by the IRS in addition to the standard procedures performed during an audit of all retail businesses. Below are industry audit procedures performed during audits of gasoline service stations.

Gasoline Service Stations

Introduction

Service stations are often very cash intensive with few employees. As such, the normal audit trail is more difficult to follow and internal controls are often lacking. Sometimes no records are maintained or they are kept sporadically and in a disorganized manner. For these situations, examiners are trained to use alternative approaches to computing income when auditing a service station. In states with sales tax, examiners may start by contacting the state agency to obtain gross sales information.

Initial Interview Questions

The initial interview questions are typically where examiners obtain the information to structure the audit. The idea is to obtain enough information to make a prediction on taxable income. Typical questions are:

1. What are your gasoline products' mark-ups per grade?
2. Was the mark-up the same in prior years?
3. What is your merchandise product mark-up?
4. Was the mark-up the same in prior years?
5. Do you have inventory on consignment (fuel, merchandise, etc.)?
6. What is your hourly rate for mechanics?
7. What is the daily gasoline sales volume? By type of gasoline? By season?
8. What is the daily merchandise sales volume? By season?
9. How often do you receive a fuel or merchandise load?
10. Do you accept credit card sales? What percentage is gasoline? Cash?
11. Name all the companies you get gasoline or other products from?
12. What was the beginning and ending inventory for the year(s) in question?
13. Has the station been remodeled? When? How long was the station closed for remodeling? Who paid for the remodel? Did you receive any reimbursement for the remodel? Did you receive financial reimbursements such as business income replacement?
14. Name all of your suppliers of gasoline and other products you offer for sale.
15. What percentage of gasoline sales is full service?
16. Do you purchase blending products such as alcohol, naphtha, and transmix?
17. Do you own your delivery trucks? If yes, do you supply your own fuel? Who do you buy it from?
18. Do you distribute your product to anyone else?

19. Were you required to file a Form 720 (Excise Tax) or Form 2290 (Highway Use Tax)? Did you file it?
20. Is all fuel purchased with Federal Excise Tax included? (Examiners may want to obtain copies of sample invoices for all fuel types to verify this fact)
21. How many bulk storage tanks do you have?
22. What is the capacity of these bulk storage tanks?
23. What is the number of gallons in inventory at year-end?
24. Is gasoline ever sold as diesel fuel?
25. How do customers use propane?
26. Are other items sold or services rendered at the location(s)?

    - For example, unbranded pumps, car wash, snow plows, cigarettes, beverages, vending machines, tires, repair bays, licensing for state inspections, mini-mart, lottery tickets, etc.

27. What is the typical sales volume based on location?
28. Do you have a license to sell beer and wine?
29. Are cars for sale at the location?
30. Are there any other service station(s) owned in whole or in part as an individual, partner, and/or shareholder?

    - The examiner may search through real estate records to make this determination.

31. What is the variance in price of gasoline between your service station and other service stations in the area?
32. How many pumps does your station have? What are the grades of product being sold and are there any other types of products such as diesel fuel, propane, or blending products?
33. Have internal controls been addressed at your station? Are the internal controls currently in place the same as during the year under audit?
34. What are your State and Federal Agencies responsible for the following?:

    - Sales Tax
    - Weights & Measurements
    - Environmental Concerns
    - Measurement Standards; etc.

Income

Service Stations dispense more than gasoline. The typical station has one or more of the following sources of revenue:

- Gasoline
- Diesel Fuel

- Sale of Vehicles
- Car Wash
- Mini-Markets
- Lottery
- Check Cashing
- Propane
- Scales
- Repair Shops with or without Tow
- Towing
- Kerosene

Site Visitations

The examiner will likely request to visit your service station prior to the beginning of the audit. They will compare the prices of your station to competitors nearby, examine for offers of cash discounts, and observe how many customers are pumping their own gasoline and how many are getting full service among other things. All of these observations are in preparation for determining if income is appropriately stated on your tax return and will be compared with your answers to some of the initial interview questions listed above.

Summons the Oil Company

If initial observations suggest you are underreporting income, the examiner may consider issuing a summons to the oil company(ies) for records for its sales to your service station. The examiner must provide you with reasonable notice in advance of all contacts with third parties made regarding the determination or collection of your tax liabilities. The examiner must also provide you with record of all these third-party contacts.

Compute purchases and sales and compare to tax return

If initial observations suggest that you may be underreporting your income, the examiner may perform the following to analytically test the gross income reported on your tax return:

- Go through your Internet access for your Bureau of Labor Statistics (BLS) survey of periodic index of retail gasoline prices, listed by type of gasoline or diesel fuel and the service station regional location.
- Print a copy of the portion of the BLS Survey that covers the area where your station is located.
- Prepare spreadsheets tailored for your area using the BLS Survey information received.

  These spreadsheets will likely include: 1) company name; 2) type of gasoline sold (unleaded, and premium); 3) full or self-service; and 4) average price of gasoline per BLS Survey.

When the summoned information comes in, the examiner will then run the BLS analysis to determine gasoline and diesel fuel gross receipts using a predictive calculation comprised of gallons sold and price per gallon. They will calculate the gasoline gross receipts by multiplying the BLS price and the gasoline gallons purchased (per the summons) to compute the potential gross gasoline sales that should be included as taxable income. This predicted calculation will then be compared with the amount on the tax return to determine if your income was understated. Non-gasoline sales will also be factored in to the predicted calculation. Therefore, non-gasoline sales figures will be added to the predicted calculation of fuel sales.

Another procedure used by examiners is the comparison of the dollars and gallons-purchased information received from the Oil Company(ies) to the tax return. The dollars purchased should at least estimate the total quantities sold because it is unlikely that a service station would continue to purchase fuel if it were not offloading this fuel to customers. This is a top level estimate of the total gallons sold to customers. A price can be estimated and then multiplied by this quantity purchased to do a quick comparison to the total revenue reported in a year. Significant variances between this figure and reported taxable income must be reconciled by non-gasoline sales. Any remaining variances will be questioned by the examiner. There are additional surveys that may be utilized as well in performing some of these analytics. These will be used in addition to other audit procedures performed.

Expenses

Rent/Other Expenses

Many service stations often attempt to double expense deductions. For example, many oil companies bill service stations through the purchase invoices, for items such as rent. The taxpayer then takes the full amount of the purchase invoice as a purchase deduction and also takes the rent (again) as an "other expense" of the total ordinary business expenses. Examiners will check for this on rent statements or purchases statements. They will also examine your agreement(s) with Oil Company(ies).

Another problem with rent often occurs when individuals take the full amount shown for rent per the purchase invoices. However, most of major oil companies charge rent based on gallons purchased, but then the oil company(ies) give(s) rent rebates back. The examiner will verify that you did not report expenses that you did not actually incur as this would result in an understatement of taxable income.

Prepayment Account

Sometimes the taxpayer has a 1- or 2-cent additional per-gallon charge on the invoice. This money is placed in somewhat of a savings account. This money earns interest on the deposits. The examiner will verify that you have not claimed this as a cost of goods sold expense. These reserve accounts are included on the gasoline purchase invoices. Examiners will request some of these invoices to verify that the gasoline reserve is on a purchase invoice and that the bottom amount of the purchase invoice does not include the prepayment amount. Additionally, examiners will verify that you have included in income the interest on these items.

Rebates

Major oil companies give rebates for increased purchases. Generally, rebates are required to be offset against the purchase price of the merchandise on which rebates are computed. For this reason, examiners will look to see that you did not deduct the full amount of the purchase through cost of goods sold without reducing this number by the rebate amount

Other Taxes

Examiners are also instructed on various ways that service stations alter tax deductions for federal income tax purposes. They look for amounts equal to taxes (sales and excise) collected by the oil companies but not shown in the purchase documents summoned. They will determine whether these amounts were included in the total dollars and per-gallon figures of the summoned documents. Examiners know that the retail-selling price in the BLS Survey includes all appropriate taxes. Therefore, they will make sure that prepaid taxes are included in the purchases. It is a common practice for a gasoline station to collect the amount of sales tax or excise taxes from the consumer. Therefore, examiners are looking for the service station to make a double deduction in the form of taxes included in cost of goods sold and taxes as a separate line item expense. This double deduction results in an understatement of income for tax purposes, and examiners want to ensure that expenses have not been overstated.

Netting Taxes

The oil companies collect the pre-collected sales tax. The taxpayer receives credit for this pre-collected sales tax on their state sales tax returns. One common problem noted during audits is full deductions for the amount of the gasoline and diesel fuel purchase invoiced as purchases per return. However, many taxpayers report their gross receipts net of sales taxes. Therefore, if you report your gross receipts net of sales taxes, the examiner will verify that your purchases are reported net of the pre-collected sales tax.

Dyed Fuel

Diesel fuels and kerosene that have been dyed red have not been taxed when the fuel is delivered to a service station. Therefore, examiners will look for a notice stating either: DYED DIESEL FUEL, NONTAXABLE USE ONLY, PENALTY FOR TAXABLE USE, or DYED KEROSENE, NONTAXABLE USE ONLY, PENALTY FOR TAXABLE USE that you have posted on the retail pump where you sell dyed diesel fuel or dyed kerosene. A substantial penalty (and tax) may be imposed on you if you sell dyed fuel for taxable purposes, such as for use in a registered highway vehicle.

Blending

Some service stations sell gasoline and diesel fuel into which the operator has added previously untaxed liquid. Stations may blend to generate more sales per gallon of gasoline or diesel fuel purchased. Most often, the blender owes excise tax on this increased volume of fuel. If the examiner suspects you are not paying the tax to the government, they will perform testing to determine if the appropriate taxes have been remitted.

Imaging Reimbursement

Oil Company(ies) sometimes makes cash or property payments to a gasoline station owner for the purpose of improving the image of the owner's station - thus the name "imaging reimbursement payments." The station owner maintains title to the improvements. Improvement of the station may be contingent upon the station owner purchasing a specified volume of petroleum products.

Issues arise because:

- The cash is usually called a no-interest loan and there is no expectation of repayment.
- Sometimes the contract reads that there is expectation of repayment but provisions are so vague that anyone can meet them and no repayment is made.
- Payments usually exceed costs involved and the taxpayer may capitalize the improvements even though he is not the true owner of the property.
- Or, people may deduct the expenses and not report the income.

Examiners are trained to look for these issues and make sure you are appropriately accounting for these types of payments.

Types of Reimbursements

The treatment of a reimbursement will vary depending on the facts and circumstances surrounding the reimbursement. The following lists out some common scenarios and outlines how examiners test to see that these payments are appropriately accounted for.

Typical Treatment by Recipient

- Cash Payments

Generally, a gasoline station owner should include the cash payment fully in gross income in the taxable year that is proper under the station owner's method of accounting. In an overwhelming majority of cases, station owners must use an accrual method of accounting. Therefore, examiners will ensure that you have recognized an amount when it is earned rather than when it is received as a payment. You are required to use an accrual method of accounting if you maintain inventory unless the Commissioner authorizes you to use a different method.

- Expenditures

You can deduct certain costs paid with monies received under an Image Upgrade Program. To be deductible, these costs must be for ordinary and necessary expenses paid or incurred in the taxable year for carrying on a trade or business. Deductible cost may include incidental repairs and advertising.

A gasoline station owner is not permitted to deduct any costs paid or incurred for new buildings or permanent improvements or betterments that increase the value or prolong the useful life of property. These costs must be treated as capital expenditures. Examiners will review the line items recorded in these types of accounts to ensure you have appropriately complied with capitalization versus expenditure rules for income tax purposes.

Questions to Answer

To determine whether an amount received should be considered a loan to you, the examiner may ask one or more of the following questions:

1. Was there a debtor-creditor relationship created at the time the proceeds in question were received by a party to the transaction?
2. Was there intent to repay the other party?
3. Did the creditor intend to enforce the "obligation"?
4. Was the transfer documented and evidenced by written agreements? (For example, is there a note?)
5. Was interest paid?
6. Was there regular repayment of principal or interest by the debtor?
7. Was there a specific date for repayment of a sum certain by the debtor? Alternatively, was the repayment predictable and realistic?

Loans typically have a repayment date and a defined periodic payment. However, it is not necessary to have a definite fixed monthly amount to have a valid loan as long as the loan meets the definition of a bona fide loan. Loan payments are not recorded as expenses on the books. Only the interest is considered an actual expense. Loan payments are offset against the debt itself. Therefore, examiners will look to verify that items are appropriately classified and that payments on loans are appropriately recorded in order to verify that you did not understate taxable income.

Shrinkage, Leakage, Theft, and Personal Use

Although taxpayers claim these as reasons for substantial loss of gallonage or a discrepancy in the cost of goods sold, these amounts are often *de minimus* at best. For this reason, examiners will have you substantiate any large amounts claimed.

Tank Replacements

This is a depreciation expense to the owner of the property, which is usually the oil company. Oil companies may pay a rebate for the stations to be shut down for remodeling or replacement of the underground storage tanks. The examiner may inspect your books to ensure that you are not claiming the depreciation expense for this asset unless you are the actual owner of the tank. If you are the actual owner, they will examine your asset schedule to ensure you are depreciating the asset over the appropriate accounting life for income tax purposes. This test may also be performed for other assets where you claim depreciation expense.

Brown, PC represents clients in retail businesses throughout Texas and across the United States. If you have questions regarding an IRS Audit, please call 888-870-0025 or contact us online for a confidential consultation.