

Audits of Online and Electronic Business Retailors

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 for retail businesses involved with online sales and electronic business.

Electronic Business / Online Retail

Introduction

Generally, e-business consists of business transactions conducted over open computer networks. To most people, e-business implies online shopping, but web shopping is only a small part of the e-business picture. From the examiner perspective, E-Business also refers to other business transactions like online stock and bond transactions, as well as electronic telemarketing. For this reason, an examiner might find that you make a substantial percentage of your purchases of goods and supplies online.

Internet Investigative Tools

The following is a list of procedures the examiner may use to determine if you are involved in E-Business or if you have a website. There is no definitive means of making this determination. Therefore, these items are suggestions, but this list is not exhaustive in nature.

1. Ask the taxpayer if he or she has a web site or use a search engine to find the retail company.
2. Most businesses want high visibility to reach customers and will register their site with the major search engines.
3. Look in the yellow pages to see if the taxpayer advertises a website.
4. Business cards will often have the name of a website on it or an e-mail address. If the domain name included in the e-mail address is similar to the taxpayer's business name, then it is very likely the taxpayer has a business web site. A company may also have brochures, flyers, etc. with a web site address that the examiner will look for.
5. Look for deductions that are common for e-business:
 - Website development costs paid for software used to create a website or to an application service provider.
 - Larger than normal depreciation deductions for web servers, networking equipment, and payments to Internet access providers.

The examiner will consult the Internet for possible websites or links to your business. They consider this inspection as important as the inspection of the physical location of the business. After the examiner has determined you have an Internet presence for your business, they will have a better ability to identify possible third-party contacts to be made and related websites and other possible businesses and relationships. To assist in this process, examiners may do one or more of the following:

- Ask you about your involvement in E-Business.
- Perform Google searches for the Domain Name based on your business and individual names.
- Save the current website content using Internet Explorer.
- Perform a LinkPopularity search to determine linked websites, related websites and other websites under your control to identify other possible sources of income.
- Use Whois to locate the Registrar and summons records.
- Use Whois to locate the Responsible Party and summons records.
- Search the Internet Archives Wayback Machine.

Audit Techniques & Interview Questions

E-Business Online Retail & Services Interview Questionnaire

The following is a list of common interview questions the examiner is likely to ask you during an initial interview:

1. Do you have an Internet presence? (web site, web page, e-mail, banner for business purposes)
2. Do you conduct business transactions over the Internet? (Accept orders and/or payments over the Internet?) (What types of records are maintained for these transactions? All electronic? Paper documents?)
3. What products, services or memberships may be purchased on your web site or through the use of email?
4. When was the web site "opened" for business? Did the business exist prior to creation of the web site? Is the business conducted over the Internet separate or distinct from the taxpayer's historic line of business?
5. What domain names have been registered either by you or on your behalf? What domain names do you have control over? Please include the date of registration and the name of the registrant.
6. How is the fee for Internet connection services determined?
7. How was your Internet web site developed, i.e. outside consultant, internal staff, web site design software? Details regarding all consulting fees, employee salaries, design software, etc. will likely be requested.
8. How many employees are engaged in the Internet-based business activity? The examiners may request a list of the employees, job titles, compensation, etc., responsible for web site design and web site hosting.
9. How much has the taxpayer paid to outside vendors including non-employee compensation, for web site development and web site hosting?
10. What type of credit card(s) does your financial institution(s) accommodate?
11. What is the name of the financial institution that clears your credit card receipts? Was an application or merchant services sign-up form completed for the credit card clearing services?
12. Does your ISP or the entity that is providing you server space process your credit card transactions?

13. Have you used any other financial institution(s) in conjunction with your web site?
14. Does your financial institution(s) provide:
 - charge authorization
 - transaction capture
 - settlement
 - charge-back handling
 - reconciliation
 - reporting, or
 - Prepaid card issuance and acceptance?
15. What type of purchase payment enabling software do you use? Examiners will make note of the vendor name and address. If you do not know the name of the software, examiners will ask if the ISP hosting the web site is providing the software.
16. How are credit sales handled and how are they recorded in gross receipts?
17. How are non-credit sales handled and how are they recorded in gross receipts?
18. How are authorized credit card product purchases processed?
19. What is the sequence from order entry to shipment?
20. How are products shipped and which shippers are used?
21. Who are your major suppliers and vendors?
22. From where are shipments made?
23. Do you have any paid referral or advertising contracts with other Internet web sites? If the answer is yes, the examiners will probably want to obtain copies of the contracts.
24. Do you swap (barter) links, banner space and server space with any other businesses?
25. Do you have any foreign operations?
26. Do you have direct or indirect control over any foreign corporations, foreign partnerships, foreign trusts or any other foreign business enterprises?
27. Do you have any direct or indirect control over foreign bank or other offshore accounts?

Identification of E-Business Cases:

Examiners are trained to examine the explanation of your business per the returns to help identify whether you are engaged in E-Business. Additionally, examiners will look for the codes to help in this determination. Some of the common types of descriptions and codes from returns indicating an E-Business are listed as follows:

Forms	NAIC Code	Explanation of Business or Products
1120, 1065, 1120S, 1040/C	425110	B2B Electronic Markets
	454110	Electronic Shopping & Mail Order Houses
	511210	Software Publishers
	516110	Internet Publishing & Broadcasting

Forms	NAIC Code	Explanation of Business or Products
	518111	Internet Service Providers
	518112	Web Search Portals
	518210	Data Processing, Hosting & Related Svcs
	541511	Custom Computer Programming Services
	541512	Computer Systems Design Services
	541513	Computer Facilities Management Svcs
	541519	Other Computer Related Services
1040/C-Only	519100	Other Information Svcs (News, Synd, Lib)
	454112	Electronic Auctions
	454111	Electronic Shopping

Examiners are also aware of certain expenses that are unique to the E-Business area. These types of expenses provide indications of Internet activity. Below is a list of expenses that examiners are looking for in determining whether you have website activity:

- Web site design costs
- Web maintenance costs
- Cable modem access
- Web consulting fees
- Network service fees
- Domain name registration fees
- Internet service provider fees
- Web page hosting fees
- Domain name cost

Certain assets included on the depreciation schedule may also indicate to the examiner that you are involved in online retail. These assets may include the following:

- Computer software
- Routers
- Phone lines
- Web site design costs
- Modems
- Telecommunication equipment

- Domain name
- Switches

Large amounts deducted for Rental or Leasing Expense and/or Utilities also indicates to an examiner that you are involved in Internet activity because many retail businesses rent or lease equipment necessary for internet activity if the necessary capital to invest in this equipment is not available. Additionally, “brick & mortar” businesses in the retail and services trade are turning to the Internet; therefore, examiners are trained to look for this type of activity.

Income

An examiner will be looking for an understatement of income when examining a tax return during an audit. The potential for omitted income is greater in E-Business, due to the paperless nature of this industry. The examiners will question you on how sales from your website are conducted and what payment types are received on these sales.

One important technique for online retail is tying the E-payment sources, such as PayPal, Visa and MasterCard, to the Books and Records and subsequently to the Tax Return. This procedure is important to make sure you have reported all income for tax purposes since it is easier to understate taxable income when there is not a paper trail. Evidence of an unreported online business can also be found by examiners through tracing credit card payments or following up on invoices.

Any business that operates a website will receive advertising income for banner ads and pop-up ads that appear on their website. Additionally, each time a site visitor clicks onto the ad, another fee is paid to the site owner. Examiners will verify you are appropriately accounting for this type of income. Many times there is a counter on the site that indicates the number of visitors to the site. The examiner may perform a predicted calculation to figure the amount of income based on the number of visits and the rate received for visits. If the examiner can determine the “click-through” rate charged, a good estimate of your income in this area can be made using predictive calculation techniques.

With online retail, the reconciliation of shipment costs with both cost of goods sold and income is another quality audit technique. The examiner will consider the average mark-up based on purchases reported and not reported to identify any unreported income. The Percentage Mark-up Technique, discussed under general retail audit procedures, for the determination of income based on cost of goods sold will be considered and employed when appropriate.

Expenses

Some expenses of an online retail business will be different, but the same tax laws apply as those for a traditional retail establishment. However, the electronic records aspect presents challenges for examiners. Therefore, they may use an IT specialist to test electronic records for accuracy to verify that you are not manipulating electronic data.

If your books and records appear questionable and internal control procedures are weak, the examiner will likely consult a third-party contact for significant and/or reoccurring expense items. This will help verify that income is not understated and that expenses are not overstated on the tax return.

Potential Tax Issues

Because of the nature of the electronic industry, the following list are risks that examiners are trained to identify when auditing a business claiming significant E-Business activity.

- Not a trade or business – When a taxpayer has claimed losses over several years from online retail activity which was used to shelter ordinary income from other sources, a determination could be made whether this activity is a business or a hobby. “Hobby losses” are not tax deductible.
- Tax Shelter – Similar to the “hobby loss” scenario, except that the examiner is looking at whether you have identified a systematic scheme to obtain losses and credits that are not allowable.
- Cost of Goods Sold - Revenue Procedure 2000-22 does not require qualifying taxpayers with average annual gross receipts of \$1,000,000 or less to account for inventories. However, if you decide not to account for inventories, you are required to treat what would have been treated as inventory as a material or supply that is not incidental under Treasury Regulation section 1.162-3. The result is that your deduction is deferred until the material or supply is consumed or sold. Examiners will likely sample some of your transactions to test whether you are in compliance with this requirement.
- Failure to Report or Failure to File – Information available indicates you have an online retail site, but the examiner cannot ascertain how your proceeds were reported. If there is no Schedule C, Partnership, or Corporate filing that has been identified, an examination must be conducted to determine tax liability using an Indirect Method discussed under the retail audit guide. Examiners are likely to contact third parties in this process.
- Omitted Online Retail Sales for an established “brick & mortar” business - Examiners know one easy way to understate income is to not recognize an entire income stream such as the online retail segment of an established traditional retail business. Segregated income streams are easily concealed by diversion. Techniques discussed earlier will help the examiner determine if you are operating in this manner.
- Use of Limited Liability Companies and Trusts structures and no 1040 returns filed - This scheme has been identified in the field involving online retail and online services businesses. An LLC is formed as the business entity for the online retail business, with Grantor Trust Partners creating a TEFRA partnership at the LLC level. The individuals involved in the business do not file 1040 returns. Examiners will look for characteristics of this type of improper reporting.
- Additionally, the following list is identified by examiners as causing potential tax issues due to the tax treatment of such items. Many of these potential issues are related to capitalization versus expensing of items and timing of deductions in these areas.

- Business Start-up Costs (Internet Business)
- Acquisition of Domain Name(s) and Website Development Costs
- Acquisition of Hardware
- Acquisition of Intangibles, including Costs of Production of Literary Content, Graphics, Sound or Video
- Acquisition of Software and Software Development Costs
- Lease Expense
- Catalog Costs
- Research & Experimental Expenditures and Credit

Brown, PC represents clients in online 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.