ARCHITECTS AND LANDSCAPE ARCHITECTS

If you are in the business of architecture or landscape architecture, the following is a synopsis of what to expect during an audit of your business by the Internal Revenue Service.

Pre-audit Analysis

Before an audit begins, the examiner will generally prepare a comparative analysis of your returns for multiple years to identify:

- large, unusual, or questionable items,
- missing schedules, statements, and/or elections,
- inconsistencies between different years, and
- audit potential.

The examiner will also obtain information about you and your business through internal and external (*e.g.*, Goggle, Accurint) sources to assist in the interview/examination process.

Information Document Request

The examiner will issue a Form 4564, Information Document Request, (IDR) which will be tailored to you, your business, and the issues the IRS intends to pursue. In addition to the typical documents requested in any audit, the examiner may request the following additional documents that relate more specifically to architecture/landscape architecture businesses:

1. **Sales –** You will likely be asked to prepare a schedule showing the breakdown, by project, of reported sales.
   You may be asked to have all project/job files, billing invoices, cash and sales journals/logs, bid sheets, change orders, addendums, notices of completion and any other documents used to record sales available for inspection.
2. **Subcontractors/Consultants –** You will be asked to prepare a schedule with the following information on each consultant or subcontractor paid:
   a. Name
   b. Telephone number and contact person
   c. The amount of money paid during the year
   d. Form of business (corporation, sole proprietorship, etc.)
   e. Federal identification number (for sole proprietors list the social security number)
   f. Description of the work/service provided

3. **Information Returns** – You will be asked to produce copies of all information returns filed (including, but not limited to Forms 1099 and W-2).
4. **Contracts** – You will be asked to produce copies all of contracts, change orders, and any addendums - these contracts will spell out what services are to be provided, the fee amount, payments to be received, etc.
5. **Bonding Information** – You will be asked to produce bonding information, including company name, address, telephone, account statements, bonding agreements, et cetera, and to provide copies of any financial statements or reports provided to the bonding company.

You will likely receive follow-up IDRs that will address other needed information as the audit progresses.

Initial Interview

The examiner may request an initial interview with you, your CFO, or other key manager in the business. The purpose of this interview is for the examiner to determine an overall financial picture of your business and to familiarize himself/herself with the business activities. Examiners may also use an initial interview to obtain leads, develop information, and establish evidence.

The examiner will likely prepare a Memorandum of Interview summarizing information obtained and statements made, which will become part of the case file.

Sample Interview Questions

Listed below are some of the questions the examiner might ask during the initial interview, in addition to normal audit questions:

1. Which personnel in your office are licensed architects?
2. How many employees and what types of positions do you have within the company?
3. For information and liability purposes, how do you keep track of all the jobs/plans which bear your stamp or that of your employees?
4. How and where do you file/store your job files?
5. How and where do you file/store your plans?
6. Do you have a formal policy on moonlighting by your employees?
7. What types of jobs/projects do you do (residential, commercial, government) and where are they located (local, state, National, international)?
8. Describe the chronology of events/processes in your operation for each type of job.
9. Do you use a standard contract in your business?
    - If the answer is “yes,” the examiner may request a copy.

- If the answer is "no," the examiner may ask you to explain what is used in the business.

10. Do you have contracts for all jobs?
    - If you answer "no," the examiner may ask how you keep track of these jobs?
11. Do your licensed architects (for a fee) ever review and stamp any plans not prepared by them or their employee(s)?
    - If the answer is "yes," the examiner may ask where the compensation is recorded.
12. Does your professional liability insurance company require a listing of all or some of your jobs on a regular basis?
    - If the answer is "yes," the examiner may request a copy.
13. What types of expenses are reimbursed by your clients? How are the reimbursements accounted for?
14. Do you submit bids for jobs?
15. What types of licenses or permits are required for each job?
16. Do you have bonding?
17. Are you required to issue certified financial statements?
18. What overall method of accounting do you use for tax? For books?
19. Do you have any special methods of accounting for tax, such as long-term contract method?
20. When is a job determined to be complete?
21. How and when are customers billed during the jobs?
22. How do you determine the price to charge for a job?
23. What costs (direct, overhead, etc.) are included in that figure?
24. Do you have a worksheet or form that you use to arrive at that figure?
25. Do you provide construction management services?
26. During the year of exam and subsequent, did you or do you now have any legal proceedings against you or against others?
27. How do you number jobs?
28. Do change orders keep the same job number or are they assigned a new job number?
29. Do you maintain a budgeting system? (monthly, quarterly, yearly)
30. Describe your job cost system:
    - Explain all costs charged to jobs
31. What types of subcontractors do you use?
32. How are subcontractors/vendors selected?
33. Do you enter into contracts with subcontractors?
34. How are subcontractor fees determined (negotiated, hourly, et cetera)?
35. Do you issue 1099s to subcontractors?
36. How do you distinguish between subcontractors and employees?

37. How is income received?
    - Percent up-front
    - Draws? How often and how determined
    - At end of contract
    - Retainages
38. What materials are purchased for each job?
39. Do subcontractors provide their own material or do you purchase it for them?
40. Do you have a warehouse/shed to keep materials?

Authority to conduct interviews

Internal Revenue Code § 7602 gives an examiner the authority to conduct interviews and request information. Section 7521(c) permits a representative authorized by you to represent you at any interview. Your presence will not usually be required as long as the person being interviewed (CFO, key manager, et cetera) has firsthand knowledge of the business, business practices, bookkeeping methods, accounting practices, and the daily operation of the business.

Some examiners may require that you be available for interview and may issue an administrative summons to you under IRC § 7521(c).

Place of Examination

IRC § 7605(a) states, *inter alia*, that "the time and place of examination shall be such time and place as may be fixed by the Secretary and as are reasonable under the circumstances."

For office examination cases the examination will be conducted in the office of the IRS closest to the taxpayer's residence in the assigned area.

For field examinations an examination will be conducted at the location where the original books, records and source documents are maintained. This may be at your principal place of business or at the offices of your representative, as provided for under Treas. Regs. § 301.7605-1(e).

Business/Activity Tour

The examiner may visit your business and/or residence, to establish that books and records accurately reflect operations, observe and test internal controls, clarify information obtained through interviews, identify potential audit issues, confirm the existence/inclusion of assets, and validate a home office deduction.

Treas. Regs. § 301.7605-1 provides that, regardless of where an examination takes place, the examiner may visit the taxpayer's place of business or residence to establish facts that can only be established by direct visit, such as inventory or asset verification. During such a visit, the examiner will look for evidence of financial status, equipment usage, undisclosed aspects of the operation, et cetera.

Books and Records

IRC § 6001 contains the requirements for taxpayers to maintain and keep records. The taxpayer must maintain adequate records to substantiate the amounts of their income and entitlement to any deductions or credits claimed.

Treas. Regs. § 1.6001-1(a) provides that taxpayers must keep permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown in the taxpayer's returns.

Treas. Regs. § 1.6001-1(e) provides that the books or records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

Whenever the taxpayer's books and records are deemed inadequate for purposes of an examination of income, the examiner may consider the issuance of an inadequate records notice at the conclusion of the examination.

Factual Development

The examiner will evaluate each large, unusual, or questionable item to determine its deductibility as a business expense.

IRC § 6201 provides examiners with the authority to resolve issues and to make determinations of tax liability.

Determining the Proper Method of Accounting

The examiner will determine whether an appropriate method of accounting is being used in the business.

Generally, architects and landscape architects are permitted to select the cash or accrual methods of accounting. They are not permitted to use the completed contract method of accounting or the percentage-of-completion method of accounting.

IRC § 446(a) provides that taxable income must be computed under the method of accounting on the basis of which the taxpayer regularly computes income in keeping the taxpayer's books.

IRC § 446(c) generally allows a taxpayer to select the method of accounting it will use to compute its taxable income. A taxpayer is entitled to adopt any one of the permissible methods for each separate trade or business, including the cash method or an accrual method subject to certain restrictions.

Generally, permissible methods include:

- IRC § 446(c)(1) - the cash receipts and disbursements method of accounting;
- IRC § 446(c)(2) - an accrual method;
- IRC § 446(c)(3) - any other method permitted by this chapter; or
- IRC § 446(c)(4) - any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

IRC § 446(b) provides that the selected method must clearly reflect income. Under Treas. Reg. §1.446-1(c)(2)(ii), the Commissioner has the authority to permit a taxpayer to use a method of accounting that clearly reflects income even though the method is not specifically authorized by the regulations.

Cash Receipts and Disbursements Method of Accounting

Generally, the "cash method" of accounting is an acceptable method of accounting for architects and landscape architects. However, there are limitations on when this method can be used.

The general rule, as shown in Treas. Regs. § 1.446-1(c)(1)(i), requires an item to be included in income (whether in the form of cash, property, or services) in the taxable year when actually or constructively received and permits a deduction for an expense in the taxable year when paid. However, Treas. Reg. § 1.461-1 provides that if an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of such taxable year, such expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made.

Income may be actually or constructively received. If the taxpayer receives a check from a customer in Year 1 but does not deposit or cash it until Year 2, it is included in income in Year 1, when actually received. Constructive receipt occurs when the taxpayer has the unrestricted access to income that has been earned.

IRC § 448(a) generally prohibits the use of the cash receipts and disbursement method of accounting in the case of C corporations, partnerships which have a C corporation as a partner, and tax shelters in computing taxable income. However, IRC § 448(b) provides exceptions for farming business entities with gross receipts of not more than $5 million, qualified personal service corporations and partnerships in which the C corporation partner is a qualified personal service corporation (PSC).

IRC § 448(a) generally prohibits C corporations, partnerships with C corporations as partners, and tax shelters from using the cash receipts and disbursements method of accounting (cash method) if the corporation's three prior taxable years average annual gross receipts exceed $5 million. IRC § 448(b) provides an exception to this general rule if a qualified PSC meets the function and ownership tests; in this case the qualified PSC may use the cash method of accounting even if it has average gross receipts in the three prior taxable year exceeding $5 million.

A cash basis PSC that fails to meet either the function or ownership test for any taxable year must change its method of accounting for that year from the cash basis to some other basis and is then taxed at a graduated income tax rate. The only exception is where the corporation meets the gross receipts test if the average annual gross receipts for the three taxable years ending prior to the taxable year in question are less than or equal to $5 million. Temp. Treas. Reg. § 1.448-1T(f).

Accrual Method of Accounting

Treas. Reg. § 1.446-1(c)(2)(i) requires that a taxpayer use an accrual method of accounting with regard to purchases and sales of merchandise whenever IRC § 471 requires the taxpayer to account for inventories, unless otherwise authorized by the Commissioner under Treas. Reg. § 1.446-1(c)(2)(ii). The accrual method requires reporting income in the year earned and expenses in the year incurred. The purpose of an accrual method is to match income and expenses in the correct year.

Other Methods of Accounting

The "any other method" in IRC § 446(c)(3) refers to special accounting methods. For example, for construction contracts, the completed contract method and the percentage of completion method are special accounting methods.

IRC § 460 was enacted as part of the Tax Reform Act of 1986, which requires the use of percentage of completion method for long-term construction contracts. However, as with many Code sections, there are exceptions to the required use of percentage of completion method.

IRC § 460(f) defines the term "long-term contract" as any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into. The duration of the contract is irrelevant. There are two exceptions for requiring the use of percentage of completion method the home construction contract and the small contractor's exception.

Architectural contracts do not qualify as long-term contracts within the meaning of IRC § 460 (IRC § 451 for contracts entered into prior to January 11, 2001) and the taxpayers are not entitled to use a long-term contract method (completed contract or percentage of completion) of accounting for these contracts for income tax purposes.

Rev. Rul. 70-67 held that an architect is not entitled to report income on the completed contract method because an architect does not build or construct anything, but simply draws the plans and supervises the work of construction.

Rev. Rul. 80-18 similarly held that contracts for engineering services and supervision of construction do not qualify as long-term contracts. This revenue ruling states: "Like the architect's services in Rev. Rul. 70-67, the contract the taxpayer entered into did not require the taxpayer to actually construct or build anything, even though the taxpayer's services are functionally related to activities which may be the subject of long-term contracts, as defined in Treas. Reg. § 1.451-3(b)(1)(i) of the regulations." For contracts entered into after January 10, 2001, Treas. Reg. § 1.451-3 has been replaced with Treas. Reg. § 1.460(c)(1).

For example, an agreement for an architect to design and prepare the plans of a building is not a long-term contract, even if the contract requires the architect to supervise or manage the construction because the architect is not required to actually construct, build or install anything.

Although these architect and construction management contracts do not qualify for long-term methods of accounting for income tax purposes, these contracts may be reported under a long-term method of accounting for financial statement purposes, *e.g.* Generally Accepted Account Principles (GAAP). For financial statement purposes, the term "contractor" is broader and includes a contract manager and contracts for services performed by architects, engineers, and architectural or engineering design firms.

If the examiner determines that the taxpayer is on an improper method of accounting for income, the examiner will change the method by computing an IRC § 481(a) adjustment in the earliest year under examination. If an examiner discontinues the use of the long-term contract method of accounting, this constitutes a change in method of accounting to which IRC §§ 446 and 481 and the related regulations apply.

Income

IRS examiners typically expect the general architectural firm to be paid about 10 percent of the project cost for small jobs, and about 4 to 5 percent on larger jobs.

Examiners expect landscape architectural firms to be paid between 10 and 15 percent of the project costs for small jobs, and about 6 to 8 percent on larger jobs.

Examiners expect that unless the job is small, the architect will generally have progress billings rather than lump sum payments. Examiners will expect payments to be tied to the completion of various phases of the service provided by the architect, such as: schematic design, design development, construction documents, bidding or negotiation, and construction.

The examiner will expect you to have good records, and believe architects typically keep good records due to possible litigation and to check on the status and profitability of each job. The examiner will review contracts and addendums between clients and the architect, expecting each contract to spell out the services that will be provided by the architect, the fee amount, and when payment is due. The examiner will expect billing invoices to tie out to the contract amount, and all payments received to be traceable to a bank deposit.

Expenses

Examiners will expect architectural firms to have the same types of expenses as other professional businesses.

IRC § 162 allows the deduction of ordinary and necessary expenses paid or incurred to carry on any trade or business. Examiners will be on the lookout for personal expenses disguised as business deductions.

They will usually understand that the typical architectural firm will require items like: global position system (GPS) handheld devices, digital cameras, laptop computers, computer scanners, and specialized copiers. Examiners expect to find the following expenses claimed by the typical architectural firm:

- pens,
- compasses,
- drafting kits,
- colored pencils,
- sketch paper,
- drafting boards,

- specialized computer aided design (CAD) software,
- project management software,
- document management software,
- desktop publishing software,
- graphics or photo imaging software,
- office suite software, and
- video creation and editing software.

Contracts between the client and the architectural firm may contain expenses which are to be reimbursed by the client. Such expenses may include transportation, travel, blueprint copies, et cetera. Architectural firms usually either expense these items as they pay them, reporting any income or reducing claimed expenses for any reimbursements, or create an asset (advance) account. Since these reimbursable expenses are in effect loans to their clients, the examiner may expect to see an asset account.

Professional liability insurance is normally expensive due to the frequency of litigation. The insurer may require a listing of all (or some) of the projects that you are working on to determine the premium level to charge. The examiner will likely ask for this list to be compared with sales to ensure that all income is being reported.

Due to the nature of the construction business there can be a lot of litigation. In some years legal fees may be extremely large. The examiner will look to confirm payments are for current services and not for possible future litigation (an asset rather than an expense).

Expect the examiner to scrutinize any education related expenses. Education may be a deductible expense under IRC § 162. In general, under IRC § 162, a taxpayer may deduct, as an ordinary and necessary business expense, certain work-related educational expenses for education undertaken for the purpose of:

- maintaining or improving skills required in the taxpayer's employment or trade or business, or
- meeting the express requirements of his employer, or the requirement of applicable law or regulations imposed as a condition to the retention by the taxpayer of an established employment relationship status, or rate of compensation.

However, education may meet these requirements and still be considered a non-qualifying education for which expenses are not deductible, if the education is to meet the minimum educational requirements (for qualification in his present employment or other trade or business) or to enter a new trade or business. Dierker vs Comm'r, TC Memo 1994-422, held that education expenses incurred by an unregistered landscape architect were not deductible because the course work qualified him for a new trade or business.

The examiner will expect subcontractors and/or consultants to be the largest non-payroll deduction on the return. The examiner will have been taught that engineering firms, interior design firms, landscape architects, and surveyors are the typical subcontractors/consultants and that they are usually not be paid for their work until the client pays the architect. The examiner will ask you to provide a schedule of your subcontractors/consultants showing the payee name, federal identification number, dollar amount paid, telephone number, contact person, and a description of the work performed.

In reviewing the subcontractor expenses, the examiner will look for independent contractors they believe might actually be employees. Other possible examination areas include, but are not limited to:

- Related party transactions
- Bartering
- Inadequate officer compensation (S corporations and C corporations)
- Personal travel being deducted as a business expense
- Illegal kickbacks or payments to secure contracts

IRC § 162(a) authorizes a deduction for trade or business expenses only if they are ordinary and necessary. An ordinary expense is one that is normal, customary, and usual within a particular trade, business, or industry under the circumstances of the situation.

You bear the burden of proving that a claimed expense is deductible. The examiner will place on you the burden of substantiating the amount and purpose of the deduction claimed. IRC § 6001 imposes a broad recordkeeping responsibility on all taxpayers, requiring them to maintain adequate records to substantiate their tax liability. IRC § 6001 gives the IRS authority to require whatever records it deems necessary.

If you fail to provide substantiation for your position, the loss/deduction will be disallowed. The examiner does not have to provide statutory authority for not permitting a deduction; it is your burden to provide the authority that permits a deduction.

In certain circumstances, the taxpayer must meet specific substantiation requirements to be allowed a deduction under IRC § 162. See, *e.g.*, IRC § 274(d). The heightened substantiation requirements of IRC § 274(d) apply to:

(1) any traveling expense, including meals and lodging away from home;
(2) any item with respect to an activity in the nature of entertainment, amusement, or recreation;

(3) any expense for gifts; or
(4) the use of "listed property," as defined in IRC § 280F(d)(4), including any passenger automobiles.

In order to deduct such expenses, you must "substantiate by adequate records or by sufficient evidence corroborating the taxpayer's own statement":

(1) the amount of the expense or other item;
(2) the time and place of the travel, entertainment, amusement, or recreation
(3) the business purpose of the expense or other item; and
(4) the business relationship to the taxpayer of the persons entertained or receiving the described gift. IRC § 274(d).

To satisfy the adequate records requirement of IRC § 274, a taxpayer must maintain records and documentary evidence that in combination are sufficient to establish each element of an expenditure or use. Temp. Treas. Reg. § 1.274-5T(c)(1).

Penalties

Possible penalties proposed by an examiner include the accuracy-related penalty under IRC § 6662 and fraud penalty under IRC § 6663.

Tax Year

PSCs, partnerships, and S corporations generally are required to be on the calendar year end. Exceptions are made if the taxpayer can establish a business purpose for a different accounting period to the satisfaction of the Secretary. See IRC §§ 441(i), 706(b) and 1378(a), respectively, for the specific allowable years.

Legal Structure

Examiners expect architecture firms to file one of the following tax returns:

- Form 1040, U.S. Individual Income Tax Return, Schedules C, Profit or Loss from a Business,
- Form1120S, U.S. Income Tax Return for an S Corporation,
- Form1120-C, U.S. Income Tax Return for Cooperative Associations; and
- Form 1065, U.S. Return of Partnership Income.

Internal Revenue Code

Below is a list of pertinent Internal Revenue Code sections relating to architecture and landscape architecture businesses that the examiner may refer to during your audit:

§ 11(b)(2)	Section 11(a) imposes a tax on the taxable income of every corporation. Section 11(b)(1) provides graduated tax rates generally applicable to corporations. However, § 11(b)(2) provides: "Notwithstanding paragraph (1), the amount of the tax imposed by subsection (a) on the taxable income of a qualified personal service corporation (as defined in section 448(d)(2)) shall be equal to 35 percent of the taxable income."
§ 162	A deduction is allowed for all the ordinary and necessary expenses paid or incurred in carrying on any trade or business.
§ 199	The domestic production activities deduction (DPAD) allows qualified taxpayers to claim a deduction equal to the lesser of a phased in percentage of taxable income (or, if the taxpayer is an individual, adjusted gross income) or qualified production activities income (QPAI) up to 50% of allocable W-2 wages paid by the taxpayer.
§ 262	As otherwise expressly provided, no deduction shall be allowed for personal, living, or family expense.
§ 451	The amount of any item of gross income shall be included in gross income for the taxable year in which it was received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for in a different period.

Treasury Regulations

Pertinent Treasury Rulings include:

§ 1.199-3(n)	Includes the gross receipts derived from engineering and architecture services for a construction project in the U.S. in DPGR.
§ 1.446-1(a)(2)	Provides that no uniform method of accounting can be prescribed for all taxpayers and that each taxpayer shall adopt such forms and systems as are, in the taxpayer's judgment, best suited to the taxpayer's needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income.

Revenue Rulings

Pertinent Revenue Rulings include:

Rev. Rul. 70-67 Provides that an architect who does not build or construct anything but simply draws the plans and supervises the work of construction is not entitled to report income from contracts extending over more than one year on the completed contract method of accounting. The work done by the architect is not building or construction work and is in the nature of a personal service.

Rev. Rul. 74-412 Provides that individual engaged by a professional company under oral agreements on a project-by-project basis to perform architectural services on the company's premises, who is furnished office and desk space, secretarial and telephone service, necessary materials and equipment, whose compensation is related to the difficultly and estimated time required to complete a particular job, and who is subject to the company's supervision to the extent necessary for the successful completion of a particular project, is an employee of the company for purposes of the FICA, FUTA, and income tax withholding.

Rev. Rule 80-18 Provides that a taxpayer providing engineering services is not entitled to adopt or use either the completed contract or percentage of completion method of accounting. This revenue ruling discusses the similarities between an architect and engineers and Rev. Rul. 70-67.

Rev. Rul. 82-134 Provides that a taxpayer, who by contract furnishes engineering services and construction management to clients, is not entitled to use the completed contract method of accounting. The taxpayer is not required to actually construct, build, or install anything, even though the taxpayer's services are functionally related to activities that may be the subject of long-term contracts.

Brown, PC represents Architects and Landscape Architects at IRS Audits 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.