

MONEY MATTERS

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IRS Compliance Campaigns

The IRS's Large Business & International (LB&I) Division has recently taken a new approach to business tax examinations. Through the use of compliance campaigns, the LB&I is restructuring compliance work to improve the tax return selection process, identify issues representing a risk of non-compliance, and make the greatest use of limited resources. Considering the LB&I serves businesses with assets greater than \$10 million, many dealerships are subject to their oversight.

Some dealers may already be familiar with one of the campaigns, the Micro-Captive Insurance Campaign. This campaign seeks to address transactions in which a taxpayer attempts to reduce taxable income using contracts treated as insurance contracts and a related company that the parties treat as a captive insurance company. Due to the broad scope of the campaign, in some instances dealers were required to disclose their involvement with a reinsurance company. The manner in which the contracts are interpreted, administered, and applied is being reviewed to determine the appropriateness of the business practice and whether transactions are conducted at arm's length. Transactions reviewed under this campaign may also fall under another campaign, the Related Party Transactions Campaign.

The LB&I states the Related Party Transactions Campaign will focus on transactions between commonly controlled entities that provide taxpayers a means to transfer funds from a corporation to related pass through entities or shareholders. LB&I is allocating resources to this issue to determine the level of compliance in related party transactions of taxpayers in the mid-market segment. LB&I executives directed taxpayers to look at Code Section 267 for the rules applicable under this campaign. Although a thorough discussion of Code Section 267 is beyond the scope of this article, the section defines related parties and dealers may find that their operating business and real estate entity fall within these defined relationships.

While Code Section 267 disallows certain losses incurred between related parties, deductions for amounts paid between related parties are permitted. In the case of rent, the amount of rent charged must be reasonable and should be at fair market value. A proper determination of fair market rent paid between related parties is important since the IRS may disallow an excessive rent deduction and recharacterize the above-market rent as compensation to the dealer. Proper matching of the rent expense and rental income is vital as well. For related parties, the deduction for rent on the dealership must match the income reported by the related real estate entity. If the rent expense deduction is higher than the income reported, the related real estate entity may be treated as having constructive receipt of rental income even though the money has not physically been received.

The compliance campaigns represent the first initiative of the LB&I's issue-based compliance work and additional campaigns are expected to be announced in the coming months. For more information, please feel free to contact Scott Herman at 317-347-5200 or sherman@kbparrish.com.

KB PARRISH & CO. LLP
6840 Eagle Highlands Way
Indianapolis, IN 46254

(317) 347-5200
Fax: (317) 347-5211

Ryan Keith, Partner
www.kbparrish.com