Architects and Landscape Architects Audit Technique Guide

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Chapter One – Introduction and Overview

Purpose of Guide

This audit technique guide (ATG) has been developed to provide guidance to Revenue Agents and Tax Compliance Officers conducting examinations in the architect and landscape architect service industries.

The purpose of the ATG is to

- provide background about the architect and landscape architect service industries,
- identify frequent and/or unique issues,
- provide examination techniques, and
- supply applicable law and court cases.

This guide is not designed to be all inclusive nor is it legal precedent and should not be relied upon as such. It is not designed to remove the discretion given to managers and examiners in the application of a variety of audit techniques or procedures appropriate to any given examination.

The following appendixes provide additional information that will assist in the examination:

- Appendix A - Participants in the Construction Industry
- Appendix B - Industry Terms and Definitions
- Appendix C - Sample Interview Questions
- Appendix D - Resources

Some of the information contained in Chapter 1, was obtained from the Bureau of Labor Statistics, Occupational Outlook Handbook, 2010-11 Edition.

Objectives of Guide

Upon completion of this audit technique guide, the examiner will be able to:

1. Have a general understanding of the architect and landscape architect professions, and
2. Identify and develop issues specific to the architect and landscape architect professions.

Overview

Architects are comprised of two specific areas; general architects and landscape architects.

General architectural businesses are described in North American Industry Classification System (NAICS) code 541310 as:

- establishments primarily engaged in planning and designing residential, institutional, leisure, commercial, and industrial buildings and structures by applying knowledge of design, construction procedures, zoning regulations, building codes, and building materials.

Landscape architectural businesses are described in NAICS code 541320 as:

- establishments primarily engaged in planning and designing the development of land areas for projects, such as parks and other recreational areas; airports; highways; hospitals; schools; land subdivisions; and commercial, industrial, and residential areas, by applying knowledge of land characteristics, location of buildings and structures, use of land areas, and design of landscape projects.

General Architects - Background

An architectural business may provide a variety of services to their clients. These services generally include consultation, design, and supervision of design of commercial, governmental, and residential structures or buildings. The plans, specifications, and other related documents that are produced in the design phase are called construction documents.

People need places in which to live, work, play, learn, worship, meet, govern, shop, and eat. Architects are responsible for designing these places, whether they are private or public; indoors or out; rooms, buildings, or complexes.

Architects are licensed professionals trained in the art and science of building design who develop the concepts for structures and turn those concepts into images and plans.

Architects create the overall look of buildings and other structures. Buildings also must be functional, safe, and economical and must suit the needs of the people who use them. Architects consider all these factors when they design buildings and other structures.

Architects may be involved in all phases of a construction project, from the initial discussion with the client through the final delivery of the completed structure. Their duties require specific skills - designing, engineering, managing, supervising, and communicating with clients and builders. Architects spend a great deal of time explaining their ideas to clients, construction contractors, and others.

The architect and client discuss the objectives, requirements, and budget of a project. In some cases, architects provide various predesign services: conducting feasibility and

environmental impact studies, selecting a site, preparing cost analysis and land-use studies, or specifying the requirements the design must meet. For example, they may determine space requirements by researching the numbers and types of potential users of a building. The architect then prepares drawings and a report presenting ideas for the client to review.

After discussing and agreeing on the initial proposal, architects develop final construction plans that show the building's appearance and details for its construction. Accompanying these plans are drawings of the structural system; heating, ventilation and air conditioning systems (HVAC); electrical systems; communications systems; plumbing; and, possibly, site and landscape plans. The plans also specify the building materials and, in some cases, the interior furnishings. In developing designs, architects follow building codes, zoning laws, fire regulations, and other ordinances, such as those requiring easy access by people who are disabled. Computer-aided design and drafting (CADD) and building information modeling (BIM) technology has replaced traditional paper and pencil as the most common method for creating design and construction drawings. Continual revision of plans on the basis of client needs and budget constraints is often necessary.

Architects may also assist clients in obtaining construction bids, selecting contractors, and negotiating construction contracts. As construction proceeds, they may visit building sites to make sure that contractors follow the design, adhere to the schedule, use the specified materials, and meet work quality standards. The job is not complete until all construction is finished, required tests are conducted, and construction costs are paid and a Certificate of Occupancy has been issued. Sometimes, architects also provide post construction services, such as facilities management. They advise on energy efficiency measures, evaluate how well the building design adapts to the needs of occupants, and make necessary improvements.

Often working with engineers, urban planners, interior designers, landscape architects, and other professionals, architects spend a great deal of their time coordinating information from, and the work of, other professionals engaged in the same project.

They design a wide variety of buildings, such as office and apartment buildings, schools, churches, factories, hospitals, houses, and airport terminals. They also design complexes such as urban centers, college campuses, industrial parks, and entire communities.

Architects sometimes specialize in one phase of work. Some specialize in the design of one type of building—for example, hospitals, schools, or housing. Others focus on planning and predesign services or construction management and do minimal design work.

There is an increase in demand for architects with knowledge of ‘green' design. Green design, also known as sustainable design, emphasizes the efficient use of resources such as energy and water, waste and pollution reduction, conservation, and environmentally friendly design, specifications, and materials. Rising energy costs and increased concern about the environment has led to many new buildings being built ‘green.'

Architects spend most of their time in offices consulting with clients, developing reports and drawings, and working with other architects and engineers. However, they often visit construction sites to review the progress of projects.

Architectural firms sometimes outsource the drafting of construction documents and basic design for large-scale commercial and residential projects to architecture firms overseas.

Landscape Architects - Background

People enjoy attractively designed gardens, public parks and playgrounds, residential areas, college campuses, shopping centers, golf courses, and parkways. Landscape architects design these areas so they are not only functional but also beautiful and harmonious with the natural environment. They plan the location of buildings, roads, and walkways, and the arrangement of flowers, shrubs, and trees. They also design and plan the restoration of natural places disturbed by humans, such as wetlands, stream corridors, mined areas, and forested land.

Working with building architects, surveyors, and engineers, landscape architects help determine the best arrangement of roads and buildings. They also collaborate with environmental scientists, foresters, and other professionals to find the best way to conserve or restore natural resources. Once these decisions are made, landscape architects create detailed plans indicating new topography, vegetation, walkways, and other landscaping details, such as fountains and decorative features.

In planning a site, landscape architects first consider the purpose of the project and the funds available. They then analyze the natural elements of the site, such as the climate, soil, slope of the land, drainage, and vegetation. They also assess existing buildings, roads, walkways, and utilities to determine what improvements are necessary. At all stages, they evaluate the project's impact on the local ecosystem.

After studying and analyzing the site, landscape architects prepare a preliminary design. To address the needs of the client, as well as the conditions at the site, they frequently make changes before a final design is approved. They also take into account any local, state, or federal regulations, such as those protecting wetlands or historic resources. In preparing designs, computer-aided design (CAD) has become an essential tool for most landscape architects. Many landscape architects also use video simulation to help clients envision the proposed ideas and plans. For larger scale site planning, landscape architects also use geographic information systems (GIS) technology, a computer mapping system.

Throughout all phases of planning and design, landscape architects consult with other professionals, such as civil engineers, hydrologists, or building architects, involved in the project. Once the design is complete, they prepare a proposal for the client. They produce detailed plans of the site, including written reports, sketches, models, photographs, land-use studies, and cost estimates and submit them for approval by the client and by regulatory agencies. When the plans are approved, landscape architects prepare working

drawings showing all existing and proposed features. They also outline in detail the methods of construction and draw up a list of necessary materials. Landscape architects then monitor the implementation of their design, while general contractors or landscape contractors usually direct the actual construction of the site and installation of plantings.

Some landscape architects work on a variety of types of projects. Others specialize in a particular area, such as street and highway beautification, waterfront improvement projects, parks and playgrounds, or shopping centers. Still others work in regional planning and resource management; feasibility, environmental impact, and cost studies; or site construction. Increasingly, landscape architects work in environmental remediation, such as preservation and restoration of wetlands or abatement of storm water run-off in new developments. Historic landscape preservation and restoration is another area where landscape architects increasingly play a role.

Landscape architects who work for government agencies do site and landscape design for government buildings, parks, and other public lands, as well as park and recreation planning in national parks and forests. In addition, they may prepare environmental impact statements and studies on environmental issues such as public land-use planning.

Landscape architects spend most of their time in offices creating plans and designs, preparing models and cost estimates, doing research, or attending meetings with clients and other professionals involved in a design or planning project. The remainder of their time is spent at the site. During the design and planning stage, landscape architects visit and analyze the site to verify that the design can be incorporated into the landscape. After the plans and specifications are completed, they may spend additional time at the site observing or supervising the construction. Those who work in large national or regional firms can spend considerably more time out of the office traveling to sites

General Architects - Training, Other Qualifications and Advancement

There are three main steps in becoming an architect: completing a professional degree in architecture; gaining work experience through an internship; and attaining licensure by passing the Architect Registration Exam.

In most states, architects must hold a professional degree in architecture from a school of architecture that has a degree program accredited by the National Architectural Accrediting Board (NAAB).

Each jurisdiction sets its own requirements for initial registration, examination, and corporate practice. The National Council of Architectural Registration Boards (NCARB) has information on each individual jurisdiction.

Most architects earn their professional degree through a five-year Bachelor of Architecture degree program which is intended for students with no previous

architectural training. Others earn a master's degree after completing a bachelor's degree in another field or after completing a pre-professional architecture program. A master's degree in architecture can take 1 to 5 years to complete depending on the extent of previous training in architecture.

The choice of degree depends on preference and educational background. A five-year Bachelor of Architecture offers the most direct route to the professional degree. A typical program includes courses in architectural history and theory, building design with an emphasis on CADD, structures, technology, construction methods, professional practice, math, physical sciences, and liberal arts.

Many schools of architecture also offer post professional degrees for those who already have a bachelor's or master's degree in architecture or other areas. Although graduate education beyond the professional degree is not required for practicing architects, it may be useful for research, teaching, and certain specialties.

All state architectural registration boards require architecture graduates to complete a training period - usually at least 3 years - before they may sit for the licensing exam. Every state follows the training standards established by the Intern Development Program, a program of the American Institute of Architects (AIA) and the NCARB. These standards stipulate broad training under the supervision of a licensed architect. Most new graduates complete their training period by working as interns at architectural firms. Some states allow a portion of the training to occur in the offices of related professionals, such as engineers or general contractors. Architecture students who complete internships while still in school can count some of that time toward the 3-year training period.

Interns in architectural firms may assist in the design of one part of a project, help prepare architectural documents or drawings, build models, or prepare construction drawings on CADD. Interns also may research building codes and materials or write specifications for building materials, installation criteria, the quality of finishes, and other related details.

All states and the District of Columbia require individuals to be licensed (registered) before they may call themselves architects and contract to provide architectural services. During the time between graduation and becoming licensed, architecture school graduates generally work in the field under the supervision of a licensed architect who takes legal responsibility for all work.

Licensing requirements include a professional degree in architecture, a period of practical training or internship, and a passing score on all divisions of the Architect Registration Examination. The eligibility period for completion of all divisions of the exam varies by state.

A roster of all licensed architects may be obtained from the appropriate state licensing authority.

Most states also require some form of continuing education to maintain a license. Requirements vary by state but usually involve the completion of a certain number of credits annually or biennially through workshops, formal university classes, conferences, self-study courses, or other sources.

Architects must be able to communicate their ideas visually to their clients. Artistic and drawing ability is helpful, but not essential, to such communication. Computer skills are also required for writing specifications, for two-dimensional and three-dimensional drafting using CADD programs, and for financial management.

A number of architects voluntarily seek certification by the NCARB. Certification is awarded after independent verification of the candidate's educational transcripts, employment record, and professional references. Certification can make it easier to become licensed across states. It is the primary requirement for reciprocity of licensing among state boards that are NCARB members. In 2009, approximately one-third of all licensed architects had this certification.

In large firms, architects may advance to supervisory or managerial positions. Some architects become partners in established firms, while others set up their own practices. Some graduates with degrees in architecture also enter related fields, such as graphic, interior, or industrial design; urban planning; real estate development; civil engineering; and construction management.

Architects held about 141,200 jobs in 2008. Approximately 68 percent of jobs were in the architectural, engineering, and related services industry. A small number worked for residential and nonresidential building construction firms and for government agencies responsible for housing, community planning, or construction of government buildings, such as the U.S. Departments of Defense and Interior and the General Services Administration. About 21 percent of architects are self-employed.

Per the Bureau of Labor Statistics 2010-11 Occupational Outlook Handbook, the median annual wages of wage-and-salary architects were $70,320 in May 2008. The middle 50 percent earned between $53,480 and $91,870. The lowest 10 percent earned less than $41,320, and the highest 10 percent earned more than $119,220. Those just starting their internships can expect to earn considerably less.

Earnings of partners in established architectural firms may fluctuate because of changing business conditions. Some architects may have difficulty establishing their own practices and may go through a period when their expenses are greater than their income, requiring substantial financial resources.

Many firms pay tuition and fees toward advanced degree programs and continuing education requirements for their employees.

Landscape Architects - Training, Other Qualifications and Advancement

Almost every state requires landscape architects to be licensed. While requirements vary among the states, they usually include a degree in landscape architecture from an accredited school; work experience; and a passing score on the Landscape Architect Registration Examination (LARE).

A bachelor's or master's degree in landscape architecture is usually necessary for entry into the profession. Sixty-seven colleges and universities offered undergraduate or graduate programs in landscape architecture that were accredited by the Landscape Architecture Accreditation Board of the American Society of Landscape Architects in 2009. There are two undergraduate professional degrees: a Bachelor of Landscape Architecture (BLA) and a Bachelor of Science in Landscape Architecture (BSLA). These programs usually require four or five years of study for completion. Those who hold an undergraduate degree in a field other than landscape architecture can enroll in a Master of Landscape Architecture (MLA) graduate degree program, which typically takes three years of full-time study to complete. Those who hold undergraduate degrees in landscape architecture can earn their MLA in two years.

Courses required in these programs usually include subjects such as surveying, landscape design and construction, landscape ecology, site design, grading, drainage, storm water management, and urban and regional planning. Other courses include history of landscape architecture, plant and soil science, geology, professional practice, and general management. Whenever possible, students are assigned real projects, providing them with valuable hands-on experience.

Many employers recommend that prospective landscape architects complete a summer internship with a landscape architecture firm during their formal educational studies.

As of 2011, all 50 states required landscape architects to be licensed. Licensing is based on the LARE, sponsored by the Council of Landscape Architectural Registration Boards. Applicants wishing to take the exam usually need a degree from an accredited school plus one to four years of work experience under the supervision of a licensed landscape architect, although standards vary by state. For those without an accredited landscape architecture degree, most states provide alternative paths to qualify to take the LARE, usually requiring more work experience. Currently, 13 states require that a state examination be passed in addition to the LARE to satisfy registration requirements. State examinations focus on laws, environmental regulations, plants, soils, climate, and any other characteristics unique to the state.

Because requirements for licensure are not uniform, landscape architects may find it difficult to transfer their registration from one state to another. National standards include graduating from an accredited program, serving three years of internship under the supervision of a registered landscape architect, and passing the LARE can satisfy

requirements in most states. By meeting national requirements, a landscape architect can also obtain certification from the Council of Landscape Architectural Registration Boards which can be useful in obtaining reciprocal licensure in other states.

In states where licensure is required, new hires may be called "apprentices" or "intern landscape architects" until they become licensed. Their duties vary depending on the type and size of the employing firm. They may do project research or prepare working drawings, construction documents, or base maps of the area to be designed. Some are allowed to participate in the actual design of a project. However, interns must perform all work under the supervision of a licensed landscape architect. Additionally, all drawings and specifications must be signed and sealed by the licensed landscape architect, who takes legal responsibility for the work. After gaining experience and becoming licensed, landscape architects usually can carry a design through all stages of development.

A majority of states require some form of continuing education to maintain a license. Requirements usually involve the completion of workshops, seminars, formal university classes, conferences, self-study courses, or other classes.

Landscape architects must be able to convey their ideas to other professionals and clients and to make presentations before large groups. Landscape architects must also be able to draft and design using CAD software. Knowledge of computer applications of all kinds, including word processing, desktop publishing, and spreadsheets is also important. Landscape architects use these tools to develop presentations, proposals, reports, and land impact studies for clients, colleagues, and superiors.

After several years, landscape architects may become project managers, taking on the responsibility for meeting schedules and budgets, in addition to overseeing the project design. Later, they may become associates or partners of a firm, with a proprietary interest in the business.

Those with landscape architecture training also qualify for jobs closely related to landscape architecture, and may, after gaining some experience, become construction supervisors, land or environmental planners, or landscape consultants.

Per the Bureau of Labor Statistics 2010-11 Occupational Outlook Handbook, the median annual wages for landscape architects were $58,960 in May of 2008. The middle 50 percent earned between $45,840 and $77,610. The lowest 10 percent earned less than $36,520 and the highest 10 percent earned more than $97,370. Architectural, engineering, and related services employed more landscape architects than any other group of industries, and the median annual wages were $59,610 in May 2008.

Legal Structure

In 2009, more than 72,000 returns with architectural services were filed in the United States. Of those filings,

- 65 percent were Form 1040 Schedules C;
- 23 percent were Form1120 S Corporations;
- 7 percent were Form1120 C Corporations; and
- 5 percent were Form 1065 Partnerships.

An architecture firm is regulated by state law. Some states do not permit an architecture firm to operate as general business corporations. This may be to ensure that only licensed architects own and control architectural firms or to make sure the public is aware of individual architects' professional liability.

Generally, architects are personally liable for their professional acts and may not transfer or otherwise assign the liability to any other party. Some states may allow (or even require) architects to organize their businesses as professional corporations. Professional corporation laws in states may set ownership restrictions to ensure that licensed architects own (or control) the business and require P.C. in the corporate name to distinguish it from a general business corporation.

Several states do not allow professional firms to organize as limited liability companies or partnerships. Other states allow the formation of professional limited liability companies (PLLCs) or professional limited liability partnerships (PLLPs)

Restrictions vary from state to state and any architectural business conducting business in a state generally must comply with the laws of that state whether or not the business maintains an office in that state.

Participants in the Construction Industry

There are numerous participants that take part in the construction process. The key participants are listed below and are discussed in depth in Appendix A.

- Contractors
- General/Prime Contractors
- Construction Managers
- Commercial Contractors
- Commercial Project Owners
- Residential Construction Developers
- Subcontractors
- Highway Contractors
- Heavy Construction Contractors
- General Architects
- Landscape Architects
- Engineers
- Material Suppliers
- Construction Lenders
- Surety Companies

Each of the above participants can and often do have multiple roles in the construction process. For example, the owner could also be the general contractor (builder/developer). The general contractor in addition to providing supervision may also do specialty work that would typically be subcontracted (for example, concrete work). Construction lenders frequently hold an equity position in a development partnership in order to participate in the management decisions and to share in the profits. Anchor tenants, such as major department store chains participate in the development partnership in exchange for signing long-term leases. Contractors and material suppliers can obtain rights in the project by filing mechanics liens against the property.

The Contracting Process

When the owner/client determines that the project is feasible and that construction financing is available, the owner will solicit bids from general contractors and/or specialty contractors. Owners will use trade publications and newspapers to invite contractors to bid for the construction contract. The notice will provide the contractors with the procedures to be followed in submitting a bid.

The bidding contractor obtains a copy of the plans and specifications prepared by the architect from the owner to prepare for the formal bid. The bidding contractor solicits bids from subcontractors, estimates direct material and labor costs, and evaluates the ultimate profit potential of the contract. The amount of the bid covers the estimated costs and profit for the construction project.

The owner evaluates the submitted bids and will award the contract to the successful bidder. The contract document contains the contract amount, project start and completion dates, progress billing procedures, insurance requirements, and other pertinent information.

In many cases, the landscape architect will oversee the bidding process on behalf of the project's owner for landscape site work that does not include extensive roadway or building work. The owner typically will then evaluate the bids after receiving review and recommendations by the landscape architect.

A few architectural firms will act as the general contractor. These general contractors make bids on the project (as described above). The architect reviews the bids and recommends one or more of the general contractors to do the job. The owner/client selects and contracts with the general contractor(s) of their choice. There may be more than one general contractor selected for different phases of the project.

Chapter 2 - Issues Common to Architects and Landscape Architects

This chapter discusses specific issues applicable to the architect and landscape architect industries. In addition to the general examination issues, there are several issues which are frequent or unique to the architectural business.

These issues are discussed in more detail below.

Personal Service Corporation

Many individuals in the business of performing personal services choose to operate as a corporation in order to gain tax advantages not otherwise available to sole proprietors or partners. Some of these advantages include the ability to deduct business expenses that would otherwise be subject to the limitations on miscellaneous itemized deductions, the graduated corporate tax rate, or the use of corporate retirement and fringe benefit plans.

Congress, concerned that personal service corporations (PSCs) were being used to shield income from the employee-owners' higher individual tax rates, made the decision to deny the benefits of the graduated tax rates to a PSC for tax years after 1987.

IRC § 11(a) imposes a tax on the taxable income of every corporation. Although for federal income tax purposes corporations generally are taxed at graduated income tax rates under IRC § 11(b)(1*)*, qualified PSCs as defined in IRC §448(d)(2*)* are taxed at a flat 35-percent income tax rate under IRC § 11(b)(2).

It is possible for a C corporation engaged in the architectural business to be a qualified PSC. A qualified PSC is one that meets the function and ownership tests of IRC § 448(d)(2).

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)).

The function test requires that substantially all of the corporation's activities involve the performance of services in the fields of "health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting" (qualifying field), IRC § 448(d)(2)(A). Section 1.448-1T(e)(4)(i) provides:

> (4) Function test - (i) In general - A corporation meets the function test if substantially all the corporation's activities for a taxable year involve the performance of services in one or more of the following fields -
>
> A. Health,
> B. Law,
> C. Engineering (including surveying and mapping),
> D. Architecture,
> E. Accounting,
> F. Actuarial science,
> G. Performing arts, or
> H. Consulting

Substantially all of the activities of a corporation are involved in the performance of services in any field described in the preceding sentence (a qualifying field), only if **95 percent or more** of the time spent by employees of the corporation, serving in their capacity as such, is devoted to the performance of services in a qualifying field. For purposes of determining whether the 95 percent test is satisfied, the performance of any activity incident to the actual performance of services in a qualifying field is considered the performance of services in that field. Activities incident to the performance of services in a qualifying field include the supervision of employees engaged in directly providing service to clients, and the performance of administrative and support services incident to such activities.

A corporation meets the ownership test if at all times during the taxable year substantially all of the corporate stock, by value, is held directly or indirectly by any of the following (Treas. Reg. § 1.448-1T(e)(5)):

- Employees performing services for the corporation in connection with the activities involving the fields of health, engineering, architecture, accounting, actuarial science, performing arts, consulting, or law.
- Retired employees who had performed the services.
- An estate of the employees or retirees described above.
- Any person who acquired the stock of the corporation as a result of the death of an employee or retiree (but only for the two-year period following the date of death).

The term "substantially all" means an amount equal to or greater than 95 percent.

Stock held indirectly includes:

- Interests owned by an individual in a partnership, S corporation, or qualified personal service corporation that owns such stock.
- Stock held by a trust if and to the extent that the individual is treated under grantor trust rules (located in Subchapter J of the Internal Revenue Code) as owner of part of the trust holding such stock.
- Stock held by any qualified pension, profit-sharing, or stock bonus plan described in IRC § 401(a) that is exempt under IRC § 501(a) (Temp Treas. Reg. §§1.448-1T(e)(5)(iii) and (v)).

Audit hint: It is important to verify that a PSC is correctly using the 35 percent tax rate *and* that when audit adjustments are proposed, Report Generation Software (RGS) correctly computes the 35 percent rate on all adjustments.

IRC § 199, Domestic Production Activities Deduction

It is possible for an architectural business to claim the IRC § 199, Domestic Production Activities Deduction (DPAD).

IRC § 199 allows a deduction equal to 9 percent (3 percent for taxable years beginning in 2005 or 2006, and 6 percent for taxable years beginning in 2007, 2008 or 2009) of the lesser of the qualified production activities Income (QPAI) of the taxpayer for the taxable year or taxable income (or, if the taxpayer is an individual, adjusted gross income) up to 50% of the allocable W-2 wages paid by the taxpayer for the taxable year.

A taxpayer's QPAI is equal to the taxpayer's domestic production gross receipts (DPGR), reduced by the cost of goods sold (CGS) that is allocable to DPGR, and other deductions, expenses and losses that are properly allocable to DPGR.

DPGR include gross receipts derived from:

- Leases, rentals, licenses, sales, exchanges or other dispositions of
    - Qualifying production property (tangible personal property, computer software and certain sound recordings) manufactured, produced grown, or extracted (MPGE) in whole or in significant part by the taxpayer in whole or significant part within the U.S.
    - Any qualified film produced by the taxpayer within the U.S.
    - Electricity, natural gas, or potable water produced by the taxpayer in the U.S.
- Construction of real property performed in the U.S. by the taxpayer.
- Engineering or **architectural services** performed in the U.S. by the taxpayer with respect to the construction of real property in the U.S.

Treas. Reg. § 1.199-3(n)(1) provides that DPGR includes gross receipts derived from engineering and architectural services performed in the United states for a construction project described in Treas. Reg. § 1.199-3(m)(1)(i), if the taxpayer is considered to be engaged in a trade or business that is considered engineering or architectural services, for

purposes of NAICS, on a regular and ongoing basis. Such qualifying services also include feasibility studies for a construction project in the U.S., even if the planned construction project is not undertaken or not completed. See Treas. Reg. §1.199-3(n)(1).

Post construction services such as annual audits and inspections do not qualify as engineering or architectural services performed for a construction project. See Treas. Reg. § 1.199-3(n)(5).

Gross receipts derived from engineering and architectural services related to the development/design of land do not qualify as DPGR because the gross receipts are not derived from engineering or architectural services performed for a construction project described in Treas. Reg. § 1.199-3(m)(1)(i), unless such services relate to "other construction activities" that constitute the erection or substantial renovation of real property in the United States as described in Treas. Reg. § 1.199-3(m)(2)(iii). For example, engineering services provided to a land developer for roads, sewers, sidewalks, and utilities qualify as DPGR because the construction of infrastructure is a qualifying activity. However, any engineering services that are related to land do not qualify unless the services relate to "other construction activities." See Treas. Reg. § 1.199-3(n)(7).

Determining the Proper Method of Accounting

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. 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.

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 § 471 requires the taxpayer to account for inventories, unless otherwise authorized by the Commissioner under Treas. Reg. § 1.446-1(c)(2)(ii).

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.

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. Therefore, you must be aware of the exceptions of IRC § 460 before determining which method of accounting is proper.

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 taxpayer 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 taxpayer is on an improper method of accounting for income, the examiner will have to change the method by computing an IRC § 481(a) adjustment in the earliest year under examination. When an examiner discontinues the use of the long-term contract method of accounting to a taxpayer as a result of the application of the above mentioned

law, this constitutes a change in method of accounting to which IRC §§ 446 and 481 and the related regulations apply.

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.

Under IRC § 444(i)(2), the taxpayer may elect to have a tax year other than a required tax year. This election is made on Form 8716, Election to Have a Tax Year Other Than a Required Tax Year. The effect of this IRC § 444 election for partnerships and S corporation is that they become subject to IRC § 7519 and must file Form 8572, Required Payment or Refund Under Section 7519, for each year the election is in effect. Form 8572 is used to figure and make the payment required under § 7519 or to obtain a refund of net prior year payments. The IRC § 444 election will end if the partnership or S corporation is penalized for willfully failing to make the required payments.

An electing PSC should not file Form 8752. Instead, it must comply with the minimum distribution requirements of IRC § 280H for each year the election is in effect. If the PSC does not meet these requirements, the applicable amounts it may deduct for payments made to its employee-owners may be limited. PSCs become subject to the deduction limitations of IRC § 280H. Of particular interest is that IRC § 280H(e) states, "...no net operating loss carryback shall be allowed to (or from) any taxable year of a PSC to which an election under section 444 applies."

Chapter 3 - Examination Techniques

This chapter covers the examination techniques specific to the architecture and landscape architecture industries.

Internal Revenue Manual (IRM) 4.10.3, *Examination Techniques*, provides guidelines for procedures and techniques that should be used in conducting an effective examination.

IRM 4.10.4, *Examination of Income*, provides guidance for the examination of income. It includes the minimum income probe requirements for all types of returns, in-depth examination techniques, and formal indirect methods**.**

Pre-audit Analysis

An in-depth pre-audit analysis is essential to conducting a quality examination. Examiners should prepare a comparative analysis of the taxpayer's returns for multiple years to assist in the identification of:

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

A successful taxpayer interview depends upon what is done before the interview. The examiner should obtain as much information about the taxpayer, be organized, and prepare an interview outline that is tailored to the taxpayer under examination. As preliminary information is gathered, it should be carefully reviewed and documented.

Information may be obtained by the use of internal sources such as IDRS, CFOL, MACS/CDE, IRP transcripts and YK-1 to assist in the examination. External electronic sources of information such as Accurint, Google, Yahoo, and Altavista should also be searched. Although these sources may not be completely factual, this information should be compared with the taxpayer's return.

Examiners should perform any preliminary research including reviewing applicable code sections, regulations, court cases, revenue rulings and procedures, and ATGs.

As preliminary information is gathered, it should be carefully reviewed and documented.

Information Document Request

The initial Information Document Request (IDR), Form 4564, for an architecture business should be tailored to the specific taxpayer under examination but will more than

likely be the same as for a typical case. In addition to the usual documents requested from taxpayers on the initial IDR, the examiner may want to consider requesting:

1. **Sales -** Prepare a schedule showing the breakdown, by project, of reported sales. 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** - Prepare a schedule with the following information on each consultant 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. **Copies of all information returns filed** (including, but not limited to Forms 1099 and W-2).
4. **Copies 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** (including company name, address, telephone, account statements, bonding agreements, etc.). Please provide copies of any financial statements or reports provided to the bonding company**.**

Subsequent IDR's should address other needed information to complete the examination.

Initial Interview

The purpose of an interview is for the examiner to secure an overall financial picture of the taxpayer and to familiarize the examiner with the business activities.

The business history should be developed and documented in the examiner's workpapers. Interviews provide information about the taxpayer's financial history, business/activity operations, and accounting records. Interviews should be used to obtain information needed to reach informed judgments about the scope of an examination and the resolution of issues. Interviews can be used to obtain leads, develop information and establish evidence.

Examiners should use short questions that can be easily understood and in a logical order. Sufficient questions should be asked to give a clear understanding of the taxpayer's operations. Follow-up questions should be used to clarify questionable areas. If both the taxpayer and preparer/authorized representative are present for the interview, direct the questions to the taxpayer. Listen to the answers and follow up on any answers that are incomplete or unclear.

Appendix C contains sample key interview questions the examiner may wish to ask at the initial interview.

The examiner should consider preparing a Memorandum of Interview summarizing information obtained and statements made. This will become part of the case file to aid in the case development.

Authority to conduct interviews

The authority to conduct interviews and request information is granted by IRC § 7602.

Every attempt should be made to schedule the initial appointment with the taxpayer. IRC § 7521(c) permits a representative authorized by the taxpayer to represent the taxpayer at any interview. Although a request for the taxpayer's voluntary presence should be made through his/her representative, the taxpayer's presence will not be mandated as long as the person being interviewed has first hand knowledge of the taxpayer's business, business practices, bookkeeping methods, accounting practices and the daily operation of the business. That person must commit to having first hand knowledge of the information requested and affirm that the examiner can rely upon the information provided.

A representative may claim to have first hand knowledge, but when questions are asked it is clear he/she is unable to give adequate answers. If an examiner determines that the representative does not have sufficient knowledge of the taxpayer and his/her business to provide factual information, the examiner should request a subsequent interview with the individual who possesses that information. The examiner should not conduct the audit with someone who will serve as a courier, shuffling back and forth between the examiner and the taxpayer with IRS questions and client answers.

If the taxpayer's representative does not comply with the request to interview someone more knowledgeable, including the taxpayer, the examiner should consider management involvement, issuing an administrative summons to the taxpayer (IRC § 7521(c)) and/or by-passing the representative. More information can be found in IRM 4.11.55.2, Power of Attorney Rights and Responsibilities.

Place of Examination

IRC § 7605(a) states, in part, 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 is usually the taxpayer's principal place of the business/activity being examined.

On a case-by-case basis, examiners should consider requests by the taxpayer or representative to change the place of the examination (Treas. Regs. § 301.7605-1(e)). In considering these requests, the following factors should be considered:

- The location of the taxpayer's current residence and location of the business/activity.
- The location where the books and records and source documents are maintained.
- The physical restrictions at the activity which could cause disruption of taxpayer's daily operations.

Business/Activity Tour

Viewing the facilities and observing the activities is an opportunity to acquire an overview of the operation, establish that books and records accurately reflect operations, observe and test internal controls, clarify information obtained through interviews, and identify potential audit issues.

Treas. Regs. § 301.7605-1 states "regardless of where an examination takes place, the Service 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." The visit can show evidence of financial status, equipment usage, undisclosed aspects of the operation, etc.

Tours should be conducted after the initial interview and early in the examination process. Examiners should be alert to the physical surroundings and confirm that assets identified on the tax return are physically present and identify assets that are physically present but are not represented on the return. Examiners should ask questions to confirm an understanding of what is observed.

When determining the validity of office in the home deductions, the office or activity should be toured.

Examiners should document that a tour was completed and describe the results, including observations and resolution of any questions. If a tour of the business/activity is not conducted, the reason(s) for not conducting the tour should be documented in the workpapers.

A Tax Compliance Officer (TCO) does not always have the opportunity to perform a physical tour of the taxpayer's activity. However, the TCO can inspect any photographs that the taxpayer may have of the activity.

Factual Development

Like any other examination, the examiner should 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. It also provides broad authority to exercise professional judgment to weigh conflicting factual information, data, and opinions on issues of law to determine the correct tax liability.

Income

Generally, the general architectural firm may be paid about 10 percent of the project cost for small jobs. For larger jobs, the percentage may drop to 4 percent or 5 percent of the project cost.

Landscape architectural firms may be paid between 10 and 15 percent of the project costs for small jobs. For larger jobs, the percentage may drop to between 6 and 8 percent of the project cost.

Unless the job is small, the taxpayer will generally have progress billings rather than lump sum payments. They often will be tied to the completion of various phases of the service provided by the architect. The phases include: schematic design, design development, construction documents, bidding or negotiation, and construction. The architect plans represent the only real leverage the architect has to secure the payment of fees. Therefore, the firm will normally have billed 80 percent to 90 percent of their fee by the start of the construction phase. Collection for all work done prior to the supervision of construction should be completed early in the construction phase.

The firm may have problems collecting the last amounts billed to clients. The client may be running low on funds; disagreements may arise on the pricing for changes or any number of other problems may occur. Some architects may choose to "walk away" rather than create ill will or litigation by sending a collection agency after their clients. Amounts not collected should only be a small percentage of the contract price. If it is a large amount or percentage, the architect may be receiving noncash payments for their services. If in doubt, the examiner should make a third party contact asking the client for verification.

Architectural firms need to have good records due to possible litigation; but more importantly, they need to know the status and profitability of each job that they work on to make good business decisions. Therefore, the job files and other records are normally well kept. Missing or incomplete job files are strong indicators of possible unreported income, which would require an expansion of the audit.

The examiner should review the contract between the client and the architect. The contract spells out the services that will be provided by the architect, the fee amount, and when payment is due. A review of the contract and any addendums of a sample of project will alert the examiner to the amount and character of the payments to be received from the project. The billing invoices should tie in to the contract amount. All payments received should be traceable to a bank deposit. Any exceptions should be fully

investigated. As a minimum check of gross income, a few projects should be tested to ensure that all funds are being deposited.

Generally, architects will keep a copy of all plans bearing their stamp either in the office or in storage due to possible litigation and/or as a basis for additional work. If they are stored in chronological order, a listing of plans completed just prior to, during, and just after the year(s) of audit can be made and compared with sales.

IRC § 6050M and Treas. Regs. § 1.6050M-1 require certain federal executive agencies to file a Form 8596, Information Return for Federal Contracts, for contracts in excess of $25,000 and longer than 120 days (with some exceptions). A contract is defined in this instance as an obligation of a federal executive agency to pay money or other property to a person in return for the sale of property, the rendering of services, or other consideration. A contract includes a written agreement between the agency and the contractor, an award or notice of award, a job order or task letter issued under a basic ordering agreement, a letter contract, an order that is effective only on written acceptance or performance, or certain increases in the amount obligated.

If a noncorporate architect acts as a subcontractor, a Form 1099-MISC should have been filed by the firm. Both a Form 8596 and a 1099-MISC will be listed on the information returns processing transcript (IRPTR) or the information returns processing on-line (IRPOL) for more current years.

Expenses

Architectural firms generally 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 should be alert for personal expenses which may be disguised as business deductions.

Items which may be unique would include global position system (GPS) handheld devices, digital cameras, laptop computers, computer scanners, specialized copiers. Examiners should 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.

The 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, etc. The architectural firm will 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, an asset account should have been created. However, since most costs are usually reimbursed within a short period of time, it may not be material enough to warrant adjustment.

The American Society of Landscape Architects (ASLA) stated that their members report that reimbursable costs may be paid at the same billing schedule as are manpower costs and it is not unusual for accounts receivable to run as much as 120 days or more with some clients.

Professional liability insurance is normally expensive due to the frequency of litigation (many firms will have rules specifically stating that their employees are not allowed to "moonlight," thus shielding the firm from another possible source of litigation.) The insurance company depends on the insured to disclose those jobs being litigated. The insured's incentive is lower premiums. As one would expect, increasing claims translates to increasing premiums. The insurer may require a listing of all (or some) of the projects that the taxpayer is working on to determine the premium level to charge. This list can 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 should ensure that payments are for current services and not for possible future litigation (an asset rather than an expense).

Education may be a deductible expense under IRC § 162. This is one area in the audit of architects where an examiner might discover otherwise nondeductible personal expenses couched as education expenses and claimed as deductible trade or business expenses 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 nonqualifying 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.

Subcontractors and/or consultants will probably be the largest nonpayroll deduction on the return. Generally they will be engineering firms, interior design firms, landscape architects, or surveyors. They usually will not be paid for their work until the client pays the architect. The examiner should ask the taxpayer to provide a schedule of their subcontractors/consultants showing the payee name, Federal identification number, dollar amount paid, telephone number, contact person, and a description of the work performed. This schedule can be used as the basis for third party checks of this expense or to pinpoint any "unusual" payees that the examiner may wish to pursue further.

In reviewing the subcontractor expenses, the examiner needs to be alert that some independent contractors might actually be employees instead. This becomes more common when firms seek to cut costs in business downturns. For further assistance regarding employment tax issues contact an employment tax specialist.

Other potential 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. A necessary expense is one that is appropriate and helpful for the business. Last the expense must be reasonable. Under IRC § 262(a), personal, living, or family expenses are generally not deductible. **Comm'r v. Heininger**, 320 U.S. 467 (1943) (holding that legal fees to contest a charge of mail fraud, that if allowed to stand, would destroy taxpayer's business were ordinary under the circumstances); **Deputy v. duPont**, 308 U.S. 488 (1949) (holding that a taxpayer/stockholder's acquisition of corporation's stock and ultimate sale to that corporation's executive committee, because the corporation itself was not legally able to do so, was not proximate to the taxpayer's business but to the corporation's.)

The IRS has authority under IRC § 7805(a) to establish rules and regulations in order to effectively administer and enforce the tax laws (Title 26 of the United States Code). A taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms. Deductions are a matter of legislative grace and strictly construed. **New Colonial Ice Co. v. Helvering**, 292 U.S. 435, 440 (1934), **INDOPCO Inc. v. Comm'r** , 503 U.S. 79, 84 (1992); **Rockwell v. Comm'r** , 512 F.2d 882, 886 (1975), affg. TCM 1972-133. A taxpayer bears the burden of proving that he or she may deduct the claimed expense; Rule 142(a), **Welch v. Helvering,** 290 U.S. 111, 115 (1933).

To take any deduction, the taxpayer must be able to cite an authority: Code, regulations, revenue rulings, notices. This includes 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 the taxpayer proves that a portion of the expenditure was made for a deductible purpose, the taxpayer may allocate that portion to the deductible purpose when the record contains sufficient evidence for a reasonable allocation. See **Dillon v. Comm'r** , 902 F.2d 406 (5th Cir. 1990).

An examiner may wish to use the following language in the revenue agent report:

> You have failed to provide any statutory authority for your position. Therefore, the loss/deduction has been disallowed. It is not IRS's burden to provide statutory authority for not permitting a deduction. It is the taxpayer's burden to provide authority in Code or in regulations or in other administrative pronouncements (tax provisions) that permits a deduction. Where there is explicit statutory authority not permitting a deduction, IRS cites that authority. However, sometimes the Government's position is simply that there is no authority in law for permitting the deduction claimed by the taxpayer.

Note: If explicit statutory authority denies the claimed loss/deduction, it may be preferable to begin the suggested paragraph by stating so. On the other hand, if there is no tax provision for permitting the claimed loss/deduction, it may be preferable to begin the paragraph noting this.

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, the taxpayer 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). Although a contemporaneous log is not required, corroborative evidence created at or near the time of the expenditure to support a taxpayer's reconstruction "of the elements ...of the expenditure or use has a high degree of probative value to elevate such statement" to the level of credibility of a contemporaneous record. Temp. Treas. Reg. § 1.274-5T(c)(1). However, corroborative evidence "not made at or near the time of the expenditure must have a high degree of credibility."

An architect was denied deductions for travel expenses and telephone costs he claimed he incurred in connection with his architecture profession. He failed to substantiate the cost and the business needs. **Shafir v. Comm'r**, TC Memo 2008-280.

Penalties

When proposing audit adjustments, penalties should always be considered. All penalties including the accuracy-related and fraud penalties are important deterrents to non-compliance.

The IRS asserts the accuracy related penalty under IRC § 6662 for negligence or disregard of rules or regulations and/or a substantial understatement of income tax in appropriate cases.

Whether the accuracy related penalty applies must be determined on a case-by-case basis and will depend on the specific facts and circumstances of each case. It is the examiner's responsibility to develop the facts and circumstances.

Inadequate Books and Records

IRC § 6001 contains the requirements for taxpayers to maintain and keep records.

Deductions are a matter of legislative grace, and the taxpayer must maintain adequate records to substantiate the amounts of their income and entitlement to any deductions or

credits claimed. IRC § 6001 (the taxpayer "shall keep such records"); **INDOPCO, Inc. v. Comm'r**, 503 U.S. 79, 84 (1992); Treas. Regs. § 1.6001-1(a).

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.

If the taxpayer has not kept adequate books and records this should be documented in the examiner's workpapers

Whenever the taxpayer's books and records are deemed inadequate for purposes of an examination of income, the examiner should consider the issuance of an inadequate records notice at the conclusion of the examination. The procedures for issuance of an inadequate records notice can be found in IRM 4.10.8, Examination of Returns.

Chapter 4 – Supporting Law

Internal Revenue Code

Various code sections may come into play whenever there is an adjustment that may involve the examination of architects, including but not limited to the following:

§ 11(b(2) - §11(a) imposes a tax on the taxable income of every corporation. § 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 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

Below are applicable Treasury regulations:

§ 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

Rev. Rul. 70-67 - 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 taxpayer is not building or construction work and is in the nature of a personal service.

Rev. Rul. 74-412 - An 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 difficult 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 - 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 – 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.

Case Law

The taxpayer or authorized representative should be requested to provide any cases which defend the taxpayer's position. The following is a list of court cases which may be of interest.

Calpo Hom & Dong Architects, Inc. v. Comm'r, TC Memo 2007-140 - A corporation that provided architectural services was a qualified personal service corporation under IRC § 448(d)(2) and, therefore, was subject to a 35 percent flat tax rate under IRC § 11(b)(2). The corporation was a qualified personal service corporation because it was 100 percent owned by licensed architects and 95 percent of its time was devoted to the performance of services in the field of architecture.

Dierker v. Comm'r, TC Memo 1994-422 (denying the deduction of education expenses as a trade or business expense under IRC § 162). Education expenses incurred by an unregistered landscape architect were not deductible under IRC § 162 because the course work qualified the architect for a new trade or business. Prior to taking the courses, the architect could not take the required state examination to become a registered landscape architect under the law of the state. After the architect took the courses, he could take the examination. The court found that the tasks and activities of a registered landscape

architect differed from that of an unregistered landscape architect. Therefore, employment as a registered landscape architect was a new trade or business. As a result, the education was not a deductible trade or business expense under IRC § 162.

Shafir v. Comm'r, TC Memo 2008-280. An architect was denied deductions for travel expenses and telephone costs he claimed he incurred in connection with his architecture profession. He failed to substantiate the cost and business needs.

Appendix

This appendix provides additional information that will assist in the case development for architectural examinations.

A - Participants in the Construction Industry

B - Glossary of Terms

C - Sample Interview Questions

D - Resources

Appendix A – Participants in the Construction Industry

Each of the below participants can and often do have multiple roles in the construction process.

Contractors	Contractors perform the construction work in accordance with the plans and specifications provided by the owner. In general, contractors are required to be licensed by state law under separate classifications (plumbing, electrical, general building, etc.).
General/Prime Contractors	A general building contractor's principal business is the performance of the construction work in accordance with the plans and specifications of the owner. A general contractor takes full responsibility for the completion of the project. Usually the general contractor subcontracts out a substantial part of the work, while maintaining overall control through project managers and onsite supervision. The general contractor can be any size and any form of entity, that is, sole proprietorship, partnership, or corporation. The general contractor may utilize specialty subcontractors or can perform any portion of the work itself. Generally contractors must be licensed. If the contractor is a corporation or partnership, an officer or partner must be licensed.
Construction Managers	Generally, the construction manager does not perform construction work on projects, but is an agent for the owner. The construction manager may be engaged in lieu of or in addition to a general contractor. As an agent, the construction manager coordinates the construction project but has no contractual relationship with the subcontractors.

Commercial Contractors	Commercial contractors specialize in commercial construction projects. These projects may include the construction of a single building or any number of buildings. Commercial projects include: • Retail Projects: Shopping centers, restaurants, grocery stores, etc. • Rental Facilities: Office building, industrial parks, apartments, etc. • Business Locations: Company headquarters, manufacturing plants, insurance companies, etc. • Municipal Buildings: City halls, prisons, schools, hospitals, etc. • Special Projects: Amusement parks, race tracks, coliseums, churches, etc.
Residential Contractors	The residential contractor usually builds for resale to one or more individual homeowners.
Commercial Project Owners	The owner of a construction project may be an individual, corporation, partnership, or government body. The owner evaluates whether a project is feasible and will provide the future benefits desired. The owner then engages an architect or engineer to design the plans and specifications of the project. Usually, the owner secures the necessary financing for the project for both the construction period and permanent financing upon completion. The owner retains title to the project throughout the construction phase, subject to liens from construction loans and mechanics liens. The general contractor may or ma not have an ownership interest in the project. The contractor may own a percentage interest in one of the following ways: 1. Owning stock in the corporation that owns the project; 2. Being a partner in a development partnership; or 3. Owning the property or an interest in a joint venture as an individual.
Residential Construction Developer	The examination of residential developers is different than the examination of a contractor who builds in accordance with a contract between the contractor and an owner. The developer is generally the owner of the residential development as well as the builder. The developer acquires land, obtains approval, secures construction financing, and

	begins construction of the residential development in stages or phases of construction. The initial phase is sold and the construction process begins on the next phase. This process requires that the builder allocate a per-unit cost to each unit sold. The cost of each unit (on-site costs such as direct materials and labor and an allocated portion of off-site costs such as streets and amenities) must be matched with the sales price of each unit sold. The sales price is often based on what the market will bear under the current economic environment. During periods of low interest rates, residential construction usually booms, while high interest rates cause the market to recede.
Subcontractors	The largest numbers of taxpayers in the construction industry are specialty subcontractors. They can range from one-man operations to nationwide, publicly traded corporations, or divisions of larger corporations. Approximately 75 percent of the construction returns filed are Schedule C returns. Subcontractors are distinguished from the general contractor by the limited scope of their work, which usually involves a special skill, knowledge, or ability. Subcontractors include specialists such as plumbers, electricians, framers, and concrete workers. They generally enter into contracts with the general contractors and may provide the raw materials used in their specialty areas. The general contractor, not the owner of the property, will usually pay the subcontractors. Materials purchased by the subcontractors are generally delivered directly to the job site. The subcontractors' work may be completed in stages or it may be continuous.
Highway Contractors	Highway and street contractors require specialized equipment and techniques. The equipment includes bulldozers, graders, dump trucks, and rollers. Examples of highway construction include city streets, freeways, country roads, highway bridges, and tunnels.
Heavy Construction Contractors	Heavy construction contractors require large and complex mechanized equipment, such as cranes, bulldozers, pile drivers, dredges, and pipe laying devices. Some examples of projects in this category include dams, large bridges, refineries, petrochemical plants, nuclear and fossil fuel power plants, pipelines, and offshore platforms. Most industrial plants are classified in this category because of the complexity of the work.
Architects/Landscape Architects/Engineers	The architect, landscape architect or engineer designs the plans to be used by the construction contractors. The plans

	provide the necessary detail (dimensions, materials to be used, location of fixtures, etc.) to the contractors. When the project is started, the architect/landscape architect/engineer may monitor the contractor's progress and often approves progress payments to the contractors. They will make modifications (change orders) in the plans as needed. Change orders are written revisions to the contract, which increase or decrease the total contract price paid to the construction contractors. The change order document contains the change order number, change order date, a description of the change, and the amount of the change order. The contractors, under the terms of the contract, can also issue change orders.
Material Suppliers	Material suppliers provide the raw materials used in the construction project. Material supplies are generally purchased by the subcontractors and installed by them in accordance with their contract. General contractors often write joint checks to subcontractors and material suppliers to ensure that all parties have been properly paid. Materials are generally delivered directly to the job site and are direct job costs, which are not normally inventoried by the contractor. In some situations the contractor will maintain inventories of miscellaneous yard stock frequently used.
Construction Lenders	The construction lender generally provides the necessary funds to pay contractors on a progress basis. In return for making the loan, the lender receives interest on the outstanding loan balance. Construction period interest (referred to as “soft costs”) paid to lenders must be capitalized by the owner during the construction period. Interest and other loan costs are often taken directly from the loan principal as a result of the institutions interest provisions. As construction work progresses, the construction lender (bank, savings and loan, insurance company, etc.) will advance the funds based on the work performed or based on a payment schedule. The construction loan is generally secured by the land and construction in progress. When construction is completed, the owner will secure permanent long-term financing.
Surety Companies	Sureties are generally insurance companies who provide bonding to contractors. Bonds provide a form of insurance to the owner (performance and bid bonds). Performance bonds protect the owner if the contractor fails to complete the construction work. Performance bonds are typically a percentage of the contract amount. Bid bonds guarantee that the contractor will sign the contract after it is awarded and

	furnish the necessary performance and payment bonds within a specified time. Contractors must submit detailed financial data to the Surety Company to secure a bond. Financial statements prepared in accordance with generally accepted accounting principles (GAAP) are often furnished to the surety on a quarterly basis or more often. Supporting schedules included in these financial statements provide extensive job information, required by the surety in order that they may analyze and limit their risk. Personal financial statements are often required to be supplied from officer shareholders.

Appendix B – Industry Terms and Definitions

Below is a listing of industry terminology.

Architect	A person who holds oneself out as able to perform, or who does perform, any professional service such as consultation, investigation, evaluation, planning, design, including aesthetic and structural design, or observation of construction, in connection with any private or public buildings, structures, or projects or the equipment or utilities thereof, or the accessories thereto, wherein the safeguarding of life, health, or property is concerned or involved, when the professional service requires the application of the art and science of construction based on the principles of mathematics, aesthetics, and the physical sciences.
Consultations	Meetings, discussions, written or verbal messages, reports, etc., involving scientific, aesthetic or technical information, facts, or advice for the purpose of planning, designing, or locating construction or alterations of structures, buildings, works, machines, processes, land areas, or projects.
Design	Any sketch, plan, drawing, outline, statement, scheme, model, contrivance, or procedure which conveys the plan, location, arrangement, intent, purpose, appearance, and nature of construction or alteration of existing or proposed buildings, structures, works, machines, processes, and area, or projects.
Domestic Production Activities Deduction IRC § 199	IRC § 199 allows a deduction equal to 9 percent (3 percent for taxable years beginning in 2005 or 2006, and 6 percent for taxable years beginning in 2007, 2008 or 2009) of the lesser of the qualified production activities Income (QPAI) of the taxpayer for the taxable year or taxable income (or, if the taxpayer is an individual, adjusted gross income) up to 50% of the allocable W-2 wages paid by the

	taxpayer for the taxable year.
	
	DPGR include gross receipts derived from:
	
	• Leases, rentals, licenses, sales, exchanges or other dispositions of
	  ○ Qualifying production property (tangible personal property, computer software and certain sound recordings) manufactured, produced grown, or extracted (MPGE) in whole or in significant part by the taxpayer in whole or significant part within the U.S.
	  ○ Any qualified film produced by the taxpayer within the U.S.
	  ○ Electricity, natural gas, or potable water produced by the taxpayer in the U.S.
	• Construction of real property performed in the U.S. by the taxpayer.
	• Engineering or **architectural services** performed in the U.S. by the taxpayer with respect to the construction of real property in the U.S.

Landscape Architect	A person who holds oneself out as able to perform professional services such as consultation, investigation, reconnaissance, research, design, preparation of drawings and specifications, and observation of construction where the dominant purpose of the services is: • The preservation and enhancement of land uses and natural land features; • The location and construction of aesthetically pleasing and functional approaches for structures, roadways, and walkways; and • The design for equestrian trails, plantings, landscape irrigation, landscape lighting, and landscape grading.
NAICS	The Office of Management and Budget's NAICS is a system for classifying establishments (individual businesses locations) by type of economic activity in Canada, Mexico and the United States. Its purpose is • to facilitate the collection, tabulation, presentation and analysis of data relating to establishments, and • to provide uniformity and comparability in the presentation and analysis of statistical data describing the North American

	economy. NAICS is used by Federal statistical agencies that collect or publish data by industry. It is also widely used by state and local agencies, trade associations, private businesses and other organizations.
Professional Engineer	A person who holds oneself out as able to perform, or who does perform, any professional service such as consultation, investigation, evaluation, planning, design or observation of construction or operation, in connection with any public or private utilities, structures, buildings, machines, equipment processes, works or projects, wherein the safeguarding of life, health or property is concerned or involved, when such professional service requires the application of engineering principles and data. There are many specialties in this filed including agriculture, chemical, civil, electrical, hydraulic, industrial, mechanical, structural and sanitary.
Specifications	The specifying of material, equipment, projects or methods to be used in the construction or alteration of buildings, structures, works, machines, processes, land areas, or projects.
Supervision of Construction	Making visits to the site by a registered engineer, architect, or landscape architect, as the case may require, to observe the progress and quality of the executive work and to determine, in general, if the work is proceeding substantially in accordance with the contract documents.
Supervision of Design	A registered engineer, architect, or landscape architect, as the case may be, shall exercise direct control and oversee the subject activity and be responsible for all work performed on plans, specifications, and other related documents.
Surveyor or Land Surveyor	A person who holds oneself out as able to make or who does make cadastral surveys of areas for their correct determination and description, either for conveyance or for the establishment or re-establishment of land boundaries or the plotting of lands and subdivisions thereof.

Appendix C – Sample Interview Questions

Listed below are questions that the examiner may consider asking the taxpayer during the initial interview. These will be in addition to the ones that are normally asked in audit. This list is not intended to be all inclusive, but should help the examiner plan the audit.

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 "yes," obtain copy. If "no," explain what is used in the business.)
10. Do you have contracts for all jobs? (If "no," how do 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 "yes," ask where is the compensation recorded.)
12. Does your professional liability insurance company require a listing of all or some of your jobs on a regular basis? (If "yes," obtain 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 assigned to 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, etc.)
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?

Appendix D – Resources

Internal sources of information:

The Internal Revenue Service website - the following publications can be found at this website:

- Publication 535, Business Expenses
- Publication 463, Travel, Entertainment, Gift and Card Expenses
- Publication 946, How to Depreciate Property
- Publication 534, Tax Guide for Small Business
- Publication 587, Business Use of Your Home

External sources of information:

The National Council of Architectural Registration Boards

The National Architectural Accrediting Board

The American Institute of Architects

American Society of Landscape Architects

Council of Landscape Architectural Registration Boards