AUDIT READY

What the IRS looks for when auditing hotel properties

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For most businesses, an IRS audit is tantamount to dark clouds looming overhead. These clouds indicate that it could rain, or the clouds could float by and the skies become clear. This analogy is typical for most businesses in regards to an IRS audit. There is always the possibility of an IRS audit, which suggests that businesses should take steps to ensure that they are prepared for such an event. This includes hospitality-related businesses which currently have a low probability of selection for an IRS audit.

Audit Frequency

To determine the probability of an audit, we did an analysis of IRS enforcement statistics for the period 2000–2009 and enforcement action data by ownership structure. To get a better understanding of the incidences of IRS audits of hospitality-related businesses, we also referenced statistics compiled by the Statistics of Income (SOI) Division for the same time period, in order to obtain a breakdown of the existing business entities by major industry sectors.

Using this information, it was possible to discern estimates of the fraction of total business entities that comprise the hospitality industry. Assuming that the IRS focused their audit efforts proportionally with the size of each industry, it is possible to superimpose the industry breakdown information over the IRS audit and enforcement action information, and estimate how many hospitality businesses were audited over the 10-year period. The analysis of the breakdown yielded a low probability of less than one percent.

IRS Hotel Industry Program

However, despite this low probability, if you are selected for an audit, some knowledge of what to expect will be helpful. The IRS provides a very useful tool, the "Hotel Industry Overview" which can be used by hospitality enterprises to prepare for an IRS audit. The following is a summary of information from this document, and discusses areas relevant to IRS audit preparation.

The IRS has an Industry Specification Program (ISP) that addresses audit issues specific to particular industries in order to achieve uniform and consistent treatment of tax audit areas. The IRS agents trained as industry specialists are called "technical advisors" and report to a technical advisor manager. The IRS's Hotel Industry Program covers taxpayers that develop, own, manage and/or operate lodging facilities, including, but not limited to, motels and full service hotels. The IRS categorizes the hotel industry into several sub-industries, which include:

- Travel accommodations
- Hotel (except casinos) and motels
- Casino hotels
- Bed and breakfast inns
- All other traveler accommodations

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- RV (recreational vehicle) parks and recreation camps
- Rooming and boarding houses

The hotel industry may also have related activities that include restaurants, cafes, theme parks, gambling, sports and recreation, retail outlets and other forms of entertainment.

The IRS regards the hotel industry as a well-established, "mature" industry characterized by intense competition, where an increase in market share usually results from a decrease in market share of a competitor. The domestic U.S. market shows little room for growth, therefore, any growth will be in the international market place. In the U.S. the IRS classifies hotels as: airport, casino, commercial, conference, economy, residential, resort, suite and all-suite hotels.

Areas for Audit Scrutiny

- Depreciable life of a hotel's small wares asset account and treatment of replacements
- Losses incurred when a hotel is closed
- Deferral of gift card sales
- Guest loyalty/reward programs
- Contributions of hotel beds
- Tax Abatements
- FICA tax tip credit
- Franchising fees
- Up-front payments
- Lobbying deductions

Terminology and Areas of Concern

The IRS defines and explains industry specific terminology, from the term "adjoining rooms" to "water-park hotel" in order to assist its auditors in fully understanding the hotel environment. IRS auditors are also aware that the majority of medium to large hotels prepare their financial statements in conformity with the *Uniform System of Accounts, for the Lodging Industry (USALI)* published by the American Hotel & Lodging Association (AH&LA). Although the *USALI* is not required for a hotel operator, it has been widely adopted. Financial statements prepared according to *USALI* provide consistency and allow for comparability between competitors. Consistent reporting methods also allow for an individual business to compare period to period, hence allowing for benchmarking. The IRS notes that *USALI* accounting has two main departmental classifications in a hotel: operating and overhead.

The operating department records revenues from various departments such as room, food and beverage, telecommunications, etc. Overhead departments include administrative and general, human resources, transportation, guest entertainment, energy costs, marketing, maintenance, telecommunications, salaries and wages, and more.

From an IRS audit viewpoint, an important area of concern lies in the hotel's revenue cycle. Because room revenue is the major source of income to a hotel, the front desk becomes the focal point of the hotel's operations. Emphasis is placed on the guest ledgers, noting the accumulation of all guest charges, such as room revenue, food and beverage, and other charges. The IRS notes that area of concern from a tax audit standpoint exists, because room rates can, and do, fluctuate considerably (e.g. individual rates vs. group rates). The occupancy rate is also an area of potential concern. This concern is not great for publicly traded companies who are required to undergo an independent external audit, but it is of considerable audit concern when it comes to privately owned companies.

In recent years, a new area of concern has arisen due to an increase in barter transactions; for example, a hotel provides accommodation in exchange for outside services, such as repair, advertising or legal services.

The Use of Ratio Analysis

The IRS uses ratio analysis to look at the reasonableness of inter-relationship between items in financial statements. In additions to ratios commonly used in all businesses, such as net profit/sales, return on investments, etc., the IRS notes ratios specific to hotels and/or restaurants that should be evaluated, such as:

Average Room Rate = Rooms Revenue /Paid Rooms Occupied.

Average Food Check = Total Food Revenue/Number of Covers (Covers = guests served in the food operation per period)

Revenue per Available Room(RevPar) = Rooms Revenue/Rooms Available for Sale or Rooms Revenue/Rooms Available

The IRS emphasizes the need for their agents to be very industry specific. It notes the *USALI's* sample chart of accounts system that many hotels use, but also that this may vary from taxpayer to taxpayer, as will the use of information systems that exist in the industry. The Overview describes briefly examples of these systems and provides sources for the auditor to obtain additional information.

The "overview" goes on to talk about industry operating procedures noting that some hotels are heavily involved in franchising and that internal controls are extensive in such chains. Internal controls in individual independent hotels are not as effective.

Significant Issues for Hotels

The Overview lists "emerging or other significant issues." A brief description of the main issues are as follows:

Depreciable life of a hotel's small wares asset account and treatment of replacements. Smallwares, that is, towels, sheets, blankets, glassware, china, silverware, linen, etc. is a potential issue relating to the selection of the correct depreciation recovery period when large quantities are purchased when a hotel opens a new location.

Losses incurred when a hotel is closed. The IRS position is that a loss on a Section 1250 property is only allowed on the actual disposition, meaning sale or abandonment, occurs. Some taxpayers have taken the position that the closing of an unprofitable location entitles them to take a loss. The IRS states the mere closing of the property is not an actual disposition.

Deferral of gift card sales. Rules relating to the deferral of gift card sales must follow Treas. Reg. S 1.451-5.

Guest loyalty/reward programs. The timing of the expense recognition treatment of reward points is determined by the characterization of the reward point, which is provided for in Treas. Reg. S 1.461-4(g)(3) and Treas. Reg. S 1.461-4(a).

Questions that may arise include: "What is the cost of a reward point? How was the estimated average cost of redeeming each point computed? Did the retailer include only the costs to acquire the merchandise, cash or other property required to redeem the points, or did the taxpayer include other costs such as advertising catalogs, transporting and storing merchandise, operating redemption centers, etc.?… Does the recurring item exception provided under Treas. Reg. § 1.461-5 apply if the reward certificate is determined to constitute a rebate?"

Contributions of hotel beds. Problems can arise in charitable contributions. Make sure the contribution is to a qualifying charitable organization and the fair market value is reasonable.

Tax abatements. The IRS has issues with the correct treatment of state and local economic development subsidies such as tax abatements that are given to companies to relocate or stay in a particular area.

FICA tax tip credit. The following questions are asked, "Should a taxpayer be allowed a credit under section 45B on service charges allocated to servers? Should a taxpayer be allowed a credit under section 45B on both directly tipped and indirectly tipped employees? Should a taxpayer be allowed a credit under section 45B for the difference paid for minimum wages for the first 90 days for employees under age 21? These are some of the issues that hotels with restaurants will face. When a service fee is charged by the restaurant, typically on large parties, banquets, or catering, these amounts are not eligible for the FICA tax tip credit under IRC § 45B."

Franchising fees. When nonrefundable franchise fees are collected up-front, the IRS looks to see that such fees are included in income.

Up-front payments. "In some situations vendors will enter into long term agreements with hotels. These contracts typically call for a large up-front payment from the vendor to the hotel. In return, the recipient agrees to purchase product for a given time period or the recipient agrees to purchase a stated amount of product in the future with no time period mentioned. The contracts will usually stipulate that the vendor will either be the exclusive supplier of the product or that the vendor is the primary vendor and will receive preferential placement of the product for an extended period of time. Typically in hotels you may see this from the soft drink provider."

Lobbying deductions. "The principal issue is whether costs incurred to influence legislation that impacts a taxpayer's business or industry are deductible as ordinary and necessary business expenses under IRC § 162(a).

The general audit approach is to determine if the activity is covered by IRC § 162(e). If yes, no deduction is permitted. If no, the activity is deductible to the extent it meets the requirements of IRC § 162(a).

Generally, IRC § 162(e)(1) provides for no deduction of amounts paid or incurred in connection with any of the following four activities:

- 'Influencing legislation' (i.e., direct lobbying of the legislature);
- Participating in a political campaign of a candidate for public office;
- Attempting to influence the public regarding elections, legislative matters or referendums (i.e. grassroots lobbying); or,
- Communicating with "covered executive branch officials."

Treas. Reg. § 1.162-29 defines 'influencing legislation' as any attempt to influence legislation through a lobbying communication and all ancillary activities engaged in for the purpose of making or supporting a lobbying communication."

The Hotel Industry Overview goes on to discuss, specific industry related tax law, important revenue rulings or revenue procedures, important court cases, technical advice memorandums-field service advises and alternative issue resolution considerations.

The guide concludes with a very useful section, "Industry Resources," which contains links to general industry related web sites, trade association publications and web sites, a list of industry books, and finally a reference to the IRS's market segment specialization program (MSSP) for Bed and Breakfasts.

Audit Ready

The chances of being audited by the IRS are low, but do increase as gross revenue increases. If your hotel is selected for an audit, it will help both you, and the auditor, to be aware of the types of things that may come up during the audit. To assist you in gaining this knowledge, the IRS has useful information available on its web site, which includes the "Hotel Industry Overview — Complete Version." Though it is stated that "This document is not an official pronouncement of the law or the position of the Service and cannot be used, or cited, or relied upon as such," it is nonetheless a useful reference. ■

Source

- IRS. "Hotel Industry Overview." http://www.irs.gov/businesses/article/0,,id=175619,00.html