MSSP

Market Segment Specialization Program

Mortuaries

The taxpayer names and addresses shown in this publication are hypothetical. They were chosen at random from a list of names of American colleges and universities as shown in Webster's Dictionary or from a list of names of counties in the United States as listed in the United States Government Printing Office Style Manual.

This material was designed specifically for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position.

Department of the Treasury
Internal Revenue Service

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Section 1

PURPOSE AND UTILIZATION OF GUIDELINE PACKAGE

The purpose of this guideline package is to give an overview of the mortuary and cemetery industry in the following areas:

1) How the industry is structured and its various functions.

2) What federal and state laws govern the industry.

3) Common industry terminology.

4) Accounting practices used in the industry for book purposes vs. proper tax treatment of various issues.

5) Tax law pertaining to the industry along with current trends affecting the industry as a result of current tax court decisions.

6) Suggested audit steps and documentation to review with regard to specific issues or accounts.

Reviewing this guide should help field agents reduce the time needed to examine returns in the areas covered by providing some familiarity prior to commencing the examination. While this guide sets forth a general overview of the industry, it is not all-inclusive.

Agents should exercise their own initiative, ingenuity and judgment in auditing and applying tax law. No interpretations of the law made here are to be cited as authority to taxpayers or used in the disposition of any case. Interpretation of the law should be made by the individual agents working the cases.

Guidelines reflected in this paper do not alter any existing technical or procedural instructions contained in the IR Manual. If there are any inconsistencies between these guidelines and the IR Manual, the IR Manual prevails.

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Section 2

CONTENTS OF GUIDELINE PACKAGE

SEGMENTS OF INDUSTRY

This guide addresses the mortuary and the cemetery businesses as separate entities, although a single business enterprise may be involved in the mortuary as well as the cemetery business. The mortuary business is that which entails the preparation of the human remains for interment and the orchestration of the funeral. The cemetery business is that of providing the final resting place for the remains.

Each section covered attempts first to familiarize the agent with the general structure and operation of each part of the industry and then offers discussion and audit suggestions on particular issues relating to them.

SOURCES OF INFORMATION

Information used in this guideline was obtained from the following:

1) Knowledge gathered during audits performed as set forth under Section 3 by a team of agents in the Los Angeles District.

2) Information obtained from reading, discussing literature about industry including, in part, the following:

   a) Code, Regulations, Revenue Rulings, Revenue Procedures, Research Services, and Committee Reports.

   b) Court cases.

   c) Magazine articles discussing industry practices and tax law pertaining to it.

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Section 3

RETURNS EXAMINED

This audit guideline was written and compiled based upon the completion of examinations on mortuary and cemetery tax returns by a team of revenue agents in the Audit Techniques Group, in the Los Angeles District. The returns examined included small cases as well as some of the larger mortuaries and taxable cemeteries in the area.

A review of this industry was made in the following format.

1) Selection of sample cases from PIA listing and telephone book.

2) Visits to local mortuary science college to review general information about the industry (books, magazines). Obtaining subscriptions to magazines focusing on the industry.

3) Review and summarization of all current law, ruling, and court cases identified as pertaining to the industry.

4) Set up general outline of industry guide, discussion of audit goals with team members.

5) Reviewing, categorizing, and assigning cases to team members.

6) Establishing a priority of procedures for working the cases.

    a) Working cases selected from small to large with team members controlling the larger cases and the case coordinator serving as a team member on each of the larger cases.

    b) Preparing case summaries on completed cases for use in preparation of this guideline.

    c) Updating guidelines as time and information became available.

    d) Acquisition and examination of related or unrelated returns which resulted from the initial cases.

7) Writing final guidelines.

Section 4

GENERAL OVERVIEW OF INDUSTRY

OVERVIEW OF INDUSTRY

During the early 1980's, the Federal Trade Commission undertook a study of the funeral industry which led to trade regulation rules requiring the industry to provide consumers with detailed information about prices and legal requirements in arranging funerals. The final rules were published in the Federal Register Vol. 47, No 186, September 24, 1982. A review of the information set forth in the Federal Register reveals the following statistical data at that time.

- There are approximately 2.0 million deaths which occur in the United States annually (1).
- The cost of the average funeral (which includes embalming, viewing, a ceremony and an in-ground burial) appears to cost between $2,000 and $3,000 dollars.
- The funeral industry in the United States is approaching $6 billion annually (2).
- While there is one major publicly traded company in the funeral business in this country (Service Corporation International Inc.), the vast majority of the business is done by privately owned businesses. As of 1982 there were:
  - over 22,000 funeral homes;
  - 50,000 licensed embalmers and funeral directors; and
  - 400 crematories in the country (3).
- While the actual number of deaths handled at a particular funeral home will vary greatly, the average number per funeral home is approximately 94. Various industry studies have indicated that up to 75 percent of funeral homes handle less than 100 funerals a year.

FOOTNOTES:

(1) 1972-1973 American Bluebook of Funeral Directors.

(2) Federal Register shows 5.2 Billion as of 1985 with source as U.S. Dept. of Commerce, U.S.

(3) 1972-1973 American Bluebook of Funeral Directors Industrial Output with projections.

- Almost half (42.9 percent) of all funeral businesses as of 1982 were individual proprietors with the rest being partnerships and corporations.

Many of the funeral home and cemetery returns reviewed and examined in preparation of this guide had been in business for a lengthy period. Many had been passed down to subsequent generations. Some had been in business for over 100 years. From discussion with taxpayers audited and the profits shown on the returns audited it appears that the industry is in good economic health. There did not appear to be any industry-threatening lawsuits currently outstanding. Industry macro charts for the mortuary and cemetery sides of the business are included at Exhibits 4-3 and 4-4.

AGENCIES REGULATING THE INDUSTRY

The funeral industry is regulated by the federal and state government in the following manner.

Federal Level

As mentioned above, the Federal Trade Commission on September 24, 1982 issued final trade regulations covering the detail of pricing and legal requirements covering funerals which must be conveyed to persons arranging funerals. These regulations were approved by Congress and went into effect April 30, 1984, an act referred to as the Funeral Rule. The rules require mortuaries and cemeteries to do the following:

Telephone Information

1) Inform potential customers calling in that price information is available over the phone.

2) Give the consumer price information from the price lists to a reasonable extent over the phone.

3) Provide any other information about prices or offering which is readily available and reasonable to answer questions.

In Person

1) Provide a price list which the consumer can keep and which will show the price of each funeral service and item.

   The price list will also contain information regarding the following:

Embalming:

a) Disclose that except in certain cases, embalming is not required by law.
b) Disclose that a direct cremation or immediate burial is available if embalming is not desired.
c) Disclose that if a particular funeral is chosen, making an embalming a necessity, that a charge will be made.
d) Cannot make a charge for unauthorized embalming.

Cash Advance Sales:

Disclose in writing whether or not the funeral director charges a fee for buying cash advance items or if the funeral home gets a discount from the price charged to the consumer (cash advance items are items which the funeral home will pay for the consumer and recoup in the final billing).

Cremation Caskets:

a) Cannot tell consumer that any law requires a casket for cremation.
b) Disclose in writing that an alternative container (an unfinished wood box or a cardboard container) can be used for cremation and make one available to the consumer.

Written Statement:

The funeral home must provide a written itemized statement of the total cost of goods purchased. Any legal, cemetery, or crematory requirements which require the consumer to purchase goods must be set forth on this statement.

State Level

Funeral homes and cemeteries are regulated to a large extent by state licensing agencies and health departments. In California, the industry is controlled by a set of rules and regulations set up by boards which are part of the State Department of Consumer Affairs, which is a part of the State and Consumer Services Agency. Mortuaries and Cemeteries are controlled by the following rules and regulations set up by the following Boards.

Cemeteries - The Cemetery Act issued by the Cemetery Board

Funeral Directors and Embalmers - The Funeral Directors and Embalmers Law issued by the State Board of Funeral Directors and Embalmers

See Exhibits 4-1 and 4-2 for a summary of important parts of the above Acts and Law.

LABOR UNIONS

No labor unions were encountered on any of the cases audited.

MAGAZINES AND OTHER SOURCES OF INFORMATION

Industry magazines relating to the industry include the following:

1) Mortuary Management Magazine - This is a trade publication designed for funeral directors and their associates. Included are manufacturers and jobbers of mortuary supplies, equipment and merchandise. It is published monthly except for July. The publisher is Berg Publications, Inc. 315 Silver Lake Boulevard, Los Angeles, California 90026. The subscription price is $25.00 per year.

2) Cemetery Management Magazine - This is a monthly publication which deals with cemetery topics like cremation; articles on death, dying and grief; news and tidbits about individuals known in the industry; and the current news in the cemetery business. This is published by the American Cemetery Association, 5201 Leesburg Pike, Suite 1111, Falls Church, Virginia 22041. Annual subscription is $45.00. The telephone number is (703) 379-5838.

3) American Cemetery Magazine - This is a monthly publication with a style similar to "Mortuary Management Magazine." Publisher is Kates-Boylston, located at 1501 Broadway, New York, New York 10036. Annual subscription is $18.00. Telephone number is (212) 398-9266.

Books written on the mortuary and cemetery business include the following:

1) The Funeral Directors Practice Management Handbook by Howard C. Raether - This book covers all phases of funeral home operation including accounting systems, management and marketing practices, forms to use in the funeral business, the law and funeral service practice. The book is available at the Cypress College Library if additional reading on the industry is desired.

Additional information on various aspects of the funeral industry can be located at the Cypress College Library, located at 9200 Valley View, Cypress, Calif 90630 Telephone: (714) 826-2220. Cypress College offers a degree in Mortuary Science.

STATISTICAL DATA AVAILABLE

Most mortuaries and cemeteries subscribe to monthly reports prepared by a company named Vital Statistics, to get an inkling of the volume of business their competitors have. This report lists all mortuaries and cemeteries located in the areas of Los Angeles, Long Beach, Antelope Valley, San Gabriel Valley, Pomona Valley, San Fernando Valley, Glendale and West Lost Angeles. It compiles the total number of funeral services handled by each mortuary and the total number of burials for each cemetery on the list.

One report shows the total funerals handled by a mortuary during each month and the cemetery they were interred in. Another shows the number of funerals handled by each mortuary and the district of the deceased's last residence. These reports enable the user to cross index how many of a particular mortuary's funerals were interred in a particular cemetery and where the cemetery got its business from.

The address of Vital Statistics is 114 Calle de Arboles, Redondo Beach, Calif 90277 (213)378-8028. Monthly fee is $45.00 per month. Information on these reports may be helpful if the agent has reason to believe that the mortuary or cemetery is not reporting all cases handled.

A one month sample review was also made of the death certificates filed with the Los Angeles Country Recorders Office located in the Hall of Records building. A list was made noting the deceased name, date of death and date of disposition of the funerals handled for that particular month by the mortuaries under examination at the time. This list was cross-checked with the funeral book used by the mortuaries in reporting gross receipts for income tax purposes. There were 7,410 records viewed for that month which took six days to complete.

Since this type of search is very tedious and time consuming, we do not recommend its use unless there is a strong suspicion of fraud and all other methods have been exhausted. Since the Recorders Office tends to be crowded all the time and the anticipated time of machine usage is lengthy, it is recommended that a letter is prepared with manager's approval requesting permission to scan and examine death certificates for the relevant year, and the time frame of your visit.

Exhibit 4-1(1 of 7)

STATE OF CALIFORNIA - FUNERAL DIRECTORS AND EMBALMERS LAW (WITH RULES AND REGULATIONS)

The Funeral Directors and Embalmers Law with Rules and Regulations is a booklet issued by the State Board of Funeral Directors and Embalmers. It is an accumulation of various parts of the California Business Professions Code, California Code of Regulations, Health and Safety Codes and the California Civil Code as they pertain to the industry. For general information purposes the table of contents, excerpts, and summaries of pertinent sections are provided below.

California Code of Regulations

Title 16

Chapter 12. Board of Funeral Directors and Embalmers
Article 1. General Provisions

Section 1203 Page 22	Filing of Addresses. Each person holding a certificate of registration, license permit or any other authority to practice or engage in any activity under the laws administered by the State Board of Funeral Directors and Embalmers is required to file his proper and current mailing address with the Board at its office in Sacramento and shall immediately notify the Board of any and all mailing address changes giving both this old and new address.

Article 2. Funeral Directors

Section 1210 Page 24	Possession of Funeral Director's License. The certificate of licensure shall remain the property of the State of California and in possession of the licensee only so long as he/she or it exercises the license at the location specified in the license and the certificate shall be surrendered to the State Board upon change of address, name, assignment or upon discontinuance of business at the specified address. This rule shall not prevent a licensed funeral director from conducting a funeral in another licensed establishment, nor shall it prevent a licensed funeral director from conducting a funeral at a church, cemetery, home, public hall, lodge room or other suitable place.
Section 1211 Page 24	Name of Funeral Establishment. A funeral establishment shall include its name, exactly as shown by the Board's records in all advertisements, including but not limited to telephone and other directory listings, radio, television and newspaper

Exhibit 4-1(2 of 7)

advertisements. Each applicant for a license shall select one specific trade name under which the license is to be issued and held. Such trade name may not include "a.k.a." designations, but must be a word or group of words combined to form one specific trade name.

Section 1212
Page 24

Manager of Funeral Establishment.
All persons, associations, partnerships, corporations or other organizations licensed and conducting business as funeral directors shall designate an individual who has taken and passed the funeral director's examination, as manager of that business.

Section 1213
Page 25

Change in Corporate Officers, Manager or Ownership.
Changes in corporate officers, including names and titles, new manager, shall be reported to the Board. Any transfer, in a single or in a related series of transactions, of more than 50 percent of the equitable interest in the ownership of a licensed funeral business shall constitute a change of ownership.

Article 3. Embalming Article

Section 1214
Page 25

Authorization for Disposition With & Without Embalming.
Except as otherwise provided in Health and Safety Code Section 7304, a dead human body shall not be embalmed without the express authorization of a person having the legal right to control disposition of the remains.

Article 4. Apprentices
Article 5. Embalmer's Licenses
Article 6. Procedures Before the Board
Article 7. Miscellaneous

Article 8. Reporting of Pre-need Funds

Section 1263
Page 37

Investment of Funds Allowable.
a) The trust funds shall be invested and reinvested, and kept invested in:
    1) Bonds of or securities guaranteed by the United States, or this State, any County, City.
    2) Bonds invested in by this State's commercial banks.
    3) Certificates of deposit or other interest bearing account in any bank in this State.
    4) Investment certificates or shares in any state or federal

chartered savings and loan.

5) Other investments allowed by Section 2261 of the Civil Code.

b) No loan shall be made to any licensed funeral director nor to any owner, director, officer, partner, or stockholder of any licensed funeral director; or trustees of the trust funds, or the relatives, agents or employees of any licensed funeral director or trustees.

Section 1265 Use of Income.

Annual trust administration fee is established at a maximum of four percent of the year-end balance of the trust which is made up of all corpus received plus prior years accumulated income. Fee may only be taken from the current year income. Periodic, prorated withdrawals may be made during the year as long as the total withdrawals do not exceed the four percent limit.

Section 1268 Commingling of Funds.

No pre-need trust funds shall be mingled or commingled with funds of any other person, firm, or corporation.

Section 1269 Reporting of Pre-Need Funeral Trust Funds.

Each licensed funeral director who enters into any pre-need arrangements shall file with the Board on or before May 1 a written, verified or audited report pertaining to funds received and held. Firms on fiscal year may request to file on a fiscal year basis no later than 120 days from close of fiscal year. The report shall include:

a) amounts collected per contracts
b) amounts deposited with the trustee
c) amounts of expenditure of income allocable to individual accounts
d) amounts of expenditure of income paid
e) trust funds invested

Section 1275 Requirements of Pre-Need Trust Agreements.

A pre-need trust contract shall include but not be limited to the following information:

a) The name and address of the trustor.
b) The name and address of the beneficiary.
c) The names and addresses of the trustees.
d) The name, address and phone number of the funeral establishment.
e) A sequential number which shall be continuous and in order of issue.
f) A copy of the completed funeral arrangements forms including,

but not limited to, the following:

  1) A description of the merchandise and services selected which is sufficiently detailed to identify them; and
  2) Any disclosure of prices or itemization of services or merchandise which is required to be provided pursuant to State or Federal law, rule or regulation then in effect.

g) A statement that earned annual income is being credited to the account and that administrative expenses, if charged, are paid from income only.

h) A statement, in clear nontechnical language, that the contract is either a guaranteed pre-need contract or that it is a non-guaranteed pre-need contract, and, if guaranteed only in part, the services or merchandise included in the guarantee shall be specified. This statement shall be printed in bold face type and shall be located on the first page of the contract.

  1) If the contract is guaranteed, there shall be included in the contract a complete explanation of all the terms and conditions limiting the guarantee.
  2) If the contract is not guaranteed, there shall be included a complete explanation of how the trust balance will be applied to pay for services and merchandise provided at the beneficiary's death and that there may be additional payments required or a refund due.

I) A statement that the trustees of the trust will deliver the corpus of the trust and net income to the funeral director filing a certified copy of the Death Certificate and evidence that said funeral director has furnished the merchandise and services. (Corpus of the Trust means all monies paid and securities delivered pursuant to this pre-arrangement contract.)

j) A statement that the amount of revocation fee to be charged in the event of revocation, shall in no event exceed ten percent (ten percent) of the paid-in corpus and is chargeable against earned income only; and a statement that no revocation fee may be charged if the funeral director is unable to perform substantially according to the terms of the agreement.

k) In immediate proximity to the space reserved for the purchaser's signature, in a size equal to at least ten point (10-point) bold type, the following statement:

"All funds received will be deposited with the trustees within thirty (30) days and held in a trust which is fully refundable upon fifteen (15) days written notice except when the beneficiary is the recipient of public assistance, as provided in the Welfare and

Institutions Code and this trust agreement has been designated as being irrevocable thereunder."

Business and Professions Code

Division 3

Chapter 12. Funeral Directors and Embalmers Law
Article 1. Administration
Article 2. Funeral Directors

Section 7615 A funeral director is a person, partnership, association, corporation, or other organization engaged in, or conducting, or holding himself or itself out as engaged in any of the following:

a) Preparing for the transportation or burial of dead human bodies.
b) Maintaining an establishment for the care of dead human bodies.
c) Using, in connection with his or its name the words "funeral director," "undertaking" or "mortician."

Section 7623 If there is more than one funeral establishment, a separate funeral director's
Page 4 license is required for each separate location.

Section 7633 No funeral director shall charge a fee for filing a certificate of death or for
Page 5 providing copies in excess of fees set by statute.

Article 3. Embalmers
Article 4. Apprentices
Article 5. Licenses

Article 5.5 Funeral Practices Article

Section 7685.2 No funeral director shall enter into a contract for furnishing services or property until the potential purchaser is provided a written or printed list containing the following information:

a) The total charge for the funeral director's services and the use of his facilities, preparation of the body, charge for the use of automotive and other equipments.
b) Itemization of charges for merchandise such as casket, clothing and outside receptacles.
c) Itemization of fees or charges and the total amount of cash

Exhibit 4-1(6 of 7)

advances made for transportation, flowers, cemetery or crematory charges, newspaper notices, clergy honoraria, transcripts, telegrams, long distance telephone calls, music and any other advance authorized by the purchaser.

d) Itemization of any fees.
e) Total of all the amounts above.

Article 6. Disciplinary Proceedings

Section 7701.5	Solicitation or acceptance by a licensee of any commission or bonus or rebate in consideration of recommending or causing the purchase of flowers from any particular florist or dealer in flowers for use in connection with a funeral service, is grounds for disciplinary action.

Article 7. Penal Provisions

Section 7737 Page 18	The trustee shall deliver the corpus of the trust to the funeral director upon the filing of a certified copy of the death certificate or other satisfactory evidence of the death of the beneficiary, together with satisfactory evidence that the funeral director has furnished the merchandise and services.

Article 8. Revenue

Article 9. Pre-Need Funeral Arrangements

Section 7735 Page 18	No funeral director or his employees shall enter or solicit any pre-need arrangement contract unless the contract requires that all money paid directly and indirectly and all securities delivered shall be held in trust until the contract is fulfilled. None of the corpus is to be used for payment of expenses. The income from the corpus may be used to pay trustee fee and to establish a reserve not to exceed ten percent of the corpus as revocation fee in the event of cancellation.
Section 7736 Page 18	Trustee-any banking institution or trust company legally authorized and empowered by the State of California to act as trustee in the handling of trust funds, or not less than three persons one of whom may be an employee of the funeral director.

Exhibit 4-1(7 of 7)

Trustor-any person who pays the money or securities for the pre-need arrangements.

Beneficiary-person for whom the funeral services are arranged.

Corpus of the trust-include moneys paid and securities delivered.

Health and Safety Code

Division 7. Dead Bodies

Chapter 1.	Definitions
Chapter 2.	General Provisions
Chapter 3.	Custody, and Duty of Interment
Chapter 3.5	Uniform Anatomical Gift Act
Chapter 3.7	Death
Chapter 4.	Disposal of Unclaimed Dead
Chapter 5.	Embalming and Transportation

Division 9. Vital Statistics

Chapter 1.	General Provisions
Chapter 2.	Administration
Chapter 4.	Fetal Death Registration
Chapter 5.	Death Registration
Chapter 7.	Permits for Disposition of Human Remains
Chapter 8.	Amendment of Records
Chapter 10.	Court Proceedings to Establish Record of Birth, Death or Marriage
Chapter 10.5	Recording Certification of Foreign Births and Deaths
Chapter 11.	Certified Copy and Verification of Records
Chapter 12.	Fees of State and Local Registrars
Chapter 14.	Penalties.

Exhibit 4-2(1 of 10)

State of California - Cemetery Act
(With Rules and Regulations)

The Cemetery Act with Rules and Regulations is a booklet issued by the State Cemetery Board. It is an accumulation of various parts of the California Business and Professions Code, Health and Safety Code, California Civil Code, and California Code of Regulations as they pertain to the cemetery industry. Below for general information purposes is the table of contents of the booklet including a brief summary of pertinent sections. Complete text is available through the audit techniques group.

Business and Professional Code

Division 3

Chapter 19. Cemeteries
Article 1. General Provisions
Article 2. Administration

Article 3. Regulations of Cemeteries

Section 9650
Page 3

Cemetery Authority in charge of cemetery endowment care funds shall file annually on or before April 1 or within three months after close of fiscal year. Various information required including:

a) The number of square feet of grave space and the number of crypts and niches sold or disposed of under endowment care by specific periods as set forth in the form prescribed.
b) The amount collected and deposited in both the general and special endowment care funds segregated as to the amounts for crypts, niches and grave space by specific periods as set forth either on the accrual or cash basis at the option of the cemetery authority.
c) A statement showing separately the total amount of the general and special endowment care funds invested in each of the investments authorized by law and the amount of cash on hand not invested, which statement shall actually show the financial condition of the funds.
d) A statement showing separately the location, description, and character of the investments in which the special endowment care funds are invested. Such statement shall show the valuations of any securities held in the endowment care fund as valued pursuant to Section 9659.
e) A statement showing the transactions entered into between the corporation or any officer, employee or stockholder thereof and the trustees of the endowment care funds with respect to such endowment

Exhibit 4-2(2 of 10)

care funds. Such statement shall show the dates, amounts of the transactions, and shall contain a statement of the reasons for such transactions.

The report shall be verified by the president or vice president and one other officer of the cemetery corporation and shall be certified by the accountant or auditor preparing the same.

The Cemetery Board form number is 27M-7.

Section 9650.1 - 9652.1 Pages 4-5	Requirements for change of filing dates, name of trustee required on report. Report is public record, and will be examined for compliance with Health and Safety Codes as to collected amounts and investment of endowment care funds. Endowment care funds shall be examined at least once every five years with the cost to be paid by the cemetery authority, to be conducted at the office of the trustee.
Section 9655 Page 5	If cemetery board examination shows that there has not been collected and deposited in the endowment care funds the minimum amounts required by H&S code, the board shall require the cemetery corporation to comply with Sections 8743 and 8744 of H&S code (refer to Chapter 5, Article 2 page 41). (Basically requires the posting of signs at cemetery and on contracts and letterhead that the cemetery is a non-endowment care cemetery.)

Article 4. Cemetery Brokerage Regulations

Section 9676	No person shall engage in the business of, act in the capacity of, advertise or assume to act as, a cemetery broker or cemetery salesman in the state of California without first obtaining a license from the board.
Section 9679	No cemetery broker shall employ or compensate, directly or indirectly, any person for performing any of the acts within the scope of this article who is not a licensed cemetery broker, or a cemetery salesman licensed under the cemetery broker employing or compensating him. No cemetery salesman shall be employed by or accept compensation from any person other than the cemetery broker under whom he is at the time licensed.

Article 5. Licenses and Certificates of Authority

Article 6. Disciplinary Proceeding

Exhibit 4-2(3 of 10)

Article 6.5 Cremated Remains Disposers

Sections 9745
Page 17

Each cremated remains disposer shall file an annual report which includes the number of cases handled and the area of scattering. Report shall cover the fiscal year ending June 30 and be due no later than September 30.

(Cremated remains disposers are required to have their license renewed yearly on September 30. The number of cases handled by the crematory during the fiscal year ending June 30 is included in this license renewal application. The board sends the crematory an annual renewal form (no form number) which asks the number of cases handled and the area of scattering. The license fee is currently $300.00 plus $.40 for each cremation.)

Article 7. Fees

Sets the maximum amounts which the Cemetery Board may charge for the various fees and licenses. (See California Code of Regulations Chapter 23 below.)

Article 8. Crematories

Exhibit 4-2(4 of 10)

Health and Safety Code

Division 7. Dead Bodies

Part 1. General Provisions

Chapter 1. Definitions
Chapter 2. General Provisions
Chapter 3. Custody and Duty of Interment

Part 2. Disinterment and Removal

Chapter 1. General Provisions
Article 1. Permits

Division 8. Cemeteries

Part 1. General Provisions

Chapter 1. Cemetery Defined

Six or more bodies being buried in one place constitutes the place a cemetery.

Chapter 2. Vandalism

Chapter 3. Records

Section 8110
Page 24

The person in charge of any premises shall keep a record of all remains interred or cremated stating the name, place of death, date of interment of the deceased person, name and address of the funeral director.

Chapter 4. Local Regulations of Cemeteries
Chapter 5. Change in Use of Cemetery

Part 3. Private Cemeteries

Chapter 1. General Provisions

Section 8250

Except as shown at subdivision © of this section, the provisions of this part do not apply to any of the following:

Exhibit 4-2(5 of 10)

a) Any religious corporation, church religious society or denomination, a corporation solely administering temporalities of any church, or religious society or denomination, or any cemetery organized, controlled, and operated by any of them.
b) Any public cemetery.
c) Any private or fraternal burial park not exceeding ten acres in area heretofore established; provided, however, (1) that the provisions of Chapter 6 (commencing at Section 8800) and Chapter 7 (commencing at Section 8825) of this part are applicable thereto, and (2) all of the provisions of this part shall apply to any such cemetery that collects a care, maintenance or embellishment deposit of funds for commodities or services.

Chapter 2. Operation and Management
Article 1. General Provisions

Section 8277
Page 26

Every contract which provides for the sale of an interment plot or any service or merchandise shall be in writing and shall disclosed the following:
a) Total contract price.
b) Terms of payment.
c) Itemized statement of charges for interment plots, burial, marker, religious services and amounts to be deposited in any endowment care fund, contract insurance and others.

Article 2. Rules and Regulations
Article 3. Police Power

Article 4. Records

Section 8330
Page 28

A record shall be kept of every interment showing the date the remains were received, date of interment, name and age of person interred.

Section 8331
Page 28

A record shall be kept of the ownership of all plots and of all transfers of plots in the cemetery.

Article 5. Operation of Crematories
Article 6. Contract Limitations

Article 7. Restrictions on Officers.

Section 8360
Page 29

No director or officer of any cemetery shall borrow any funds of the corporation.

Exhibit 4-2(6 of 10)

Chapter 3. Acquisitions, Dedication and Sale
Article 1. Acquisition of Property
Article 2. Declaration of Intention
Article 3. Dedication

Article 4. Sale of Plots

Section 8673 Any cemetery authority or its agents who sell, offer for sale, contract to sell, or negotiate the sale of mausoleum crypts before the receipt of a certificate of occupancy as provided for in Sections 9591 and 9592 shall:

a) Set forth in each contract a specific period of time within which the building or structure shall be completed.
b) Set forth in each contract that the purchaser has the right of exchange for similar interment property and, in the event completion is not accomplished as set forth in (a) above, except upon the proclamation of a national emergency, guarantee the refund of the purchase price.
c) Provide adequate financial provision for the construction cost of the mausoleum or the refund of the sales price to the purchaser until such time as a certificate of occupancy has been received.

Article 5. Removal of Dedication
Article 6. Transfer of Cemetery Ownership

Section 8585 Whenever ownership of any cemetery authority is proposed to be transferred, the cemetery authority shall notify the Cemetery Board in the Department of Consumer Affairs. A change in ownership, for purposes of this section, shall be deemed to occur whenever more than 50 percent of the equitable ownership of a cemetery authority is transferred in a single transaction or in a related series of transactions to one or more persons, associations, or corporations. The notice shall specify the address of the principal offices of the cemetery authority, and whether it will be changed or unchanged, and shall specify the name and address of each new owner and the stockholders thereof.

The existing certificate of authority will lapse and a new certificate of authority must be obtained.

Every cemetery authority shall post and continuously maintain at each public entrance to the cemetery a sign specifying the current name and address of the cemetery authority, a statement that the name and address of each director and officer of the cemetery authority may be obtained by contacting the Cemetery Board of the State of California and the address of

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the Cemetery Board.

Chapter 4. Property Rights
Article 1. General Provisions
Article 2. Joint Tenants
Article 3. Family Interment Plots
Article 4. Vested Right of Interment
Article 5. Voluntary Establishment of Inalienability

Chapter 5. Endowment and Special Care
Article 1. Care of Old Cemeteries

Article 2. Care of Active Cemeteries

Section 8725 Page 37	Every cemetery authority may place its cemetery under endowment care and establish an endowment care fund. Endowment care and special care funds may be commingled. The fund may be held in the name of the cemetery authority or its directors or in the name of the trustees appointed by the cemetery authority.
Section 8726 Page 37	The principal shall be invested and the income only may be used for the care and maintenance.
Section 8726.1 Page 37	The trustee of the fund shall create a reserve from which principal losses may be replaced by setting aside a percentage of the income from the fund. May also set aside out of income or net capital gains from investments, reserves for future maintenance not to exceed ten percent of the endowment care fund.
Section 8729 Page 38	Upon payment of the purchase price and the amount fixed as contribution for endowment care, there may be included or separately, an agreement to use the income from the fund for the care of the cemetery.
Section 8733 Page 38	Compensation for trustee services shall not exceed five percent of the income derived from the fund.
Section 8734 Page 39	Board of trustees shall file a fidelity bond in the amount of $50,000, guaranteeing payment for monetary loss by fraud.
Section 8738 Page 40	An endowment care cemetery is one which has deposited in its endowment care fund, amounts required by law and shall have deposited in the fund at

Exhibit 4-2(8 of 10)

the time of or not later than the completion of the initial sale: a) $1.75 a square foot for each grave b) $25.00 for each niche c) $75.00 for each crypt ($40.00 for each additional crypt).

Section 8738.1 Page 40	In addition, to deposit the additional sum of $25,000 or $35,000 (if established on or after 1/1/77) before disposing any plot or making any sale.
Section 8738.2 Page 40	Endowment care fund and its books and records is to be kept separate from other cemetery funds. Amount to be deposited shall be separately shown on the original purchase agreement. No commission to be paid on this amount.

Article 3. Investment of Endowment Funds
Article 4. Special Care

Section 8778 Page 44	No loan shall be made from the special care fund to the cemetery authority, director, officer or stockholder, trustees, partners, relatives, agents, or employees.

Article 5. Misrepresentation as to Endowment
Article 6. Penalties

Chapter 7. Abandonment

Part 5. Mausoleums and Columbariums

Chapter 1. General Provisions
Chapter 2. Enforcement

Chapter 3. Permits and Plans
Article 1. General Provisions
Article 2. Application, Permits and Certificate of Occupancy
Article 3. Cancellation of Permit
Article 4. Expiration of Permit

Chapter 4. Inspection and Approval

Chapter 5. Construction
Article 1. General Provisions
Article 2. Structural and Material Requirements of Community Mausoleums and Columbariums

Exhibit 4-2(9 of 10)

Article 3. Structural and Material Requirements of Private Mausoleums and Columbariums

Chapter 6. Penalties

CIVIL CODE

Section 2261 Investment of Funds

California Code of Regulations

Chapter 23. State Cemetery Board

Section 2300 Principal office of the Board is located 1434 Howe Avenue, Suite 88, Sacramento, Calif.

Article 1. General
Article 2. Fees

Section 2310-2324 Sets forth the initial and annual filing fees as follows:

Cemetery Authority

Annual fee is $300.00 plus $.40 per interment made during the preceding full calendar year.

Initial filing fee is $300.00.

Filed with the State of California

Consumer Affairs Agency. Form No. 27R-1.

Crematory

Annual fee is $300.00 plus $.40 per cremation made during the preceding full calendar year.

Initial fee is $100.00.

Cemetery Brokers Original License Fee is $225.00. Form No. 27R-2.

Cemetery Brokers Re-examination Fee is $50.00.

Cemetery Broker License Renewal Fee is $200.00.

Cemetery Broker Multiple Corporate Officer or Partner License Renewal Fee is $50.00 for each additional license.

Cemetery Broker Branch Office License Fee is $50.00.

Cemetery Broker Salesman Temporary License Fee is $20.00.

Cemetery Salesman Original License Fee is $20.00.

Cemetery Salesman Re-examination Fee is $10.00.

Cemetery Salesman License Renewal Fee is $20.00.

Article 3. Applications and Licenses

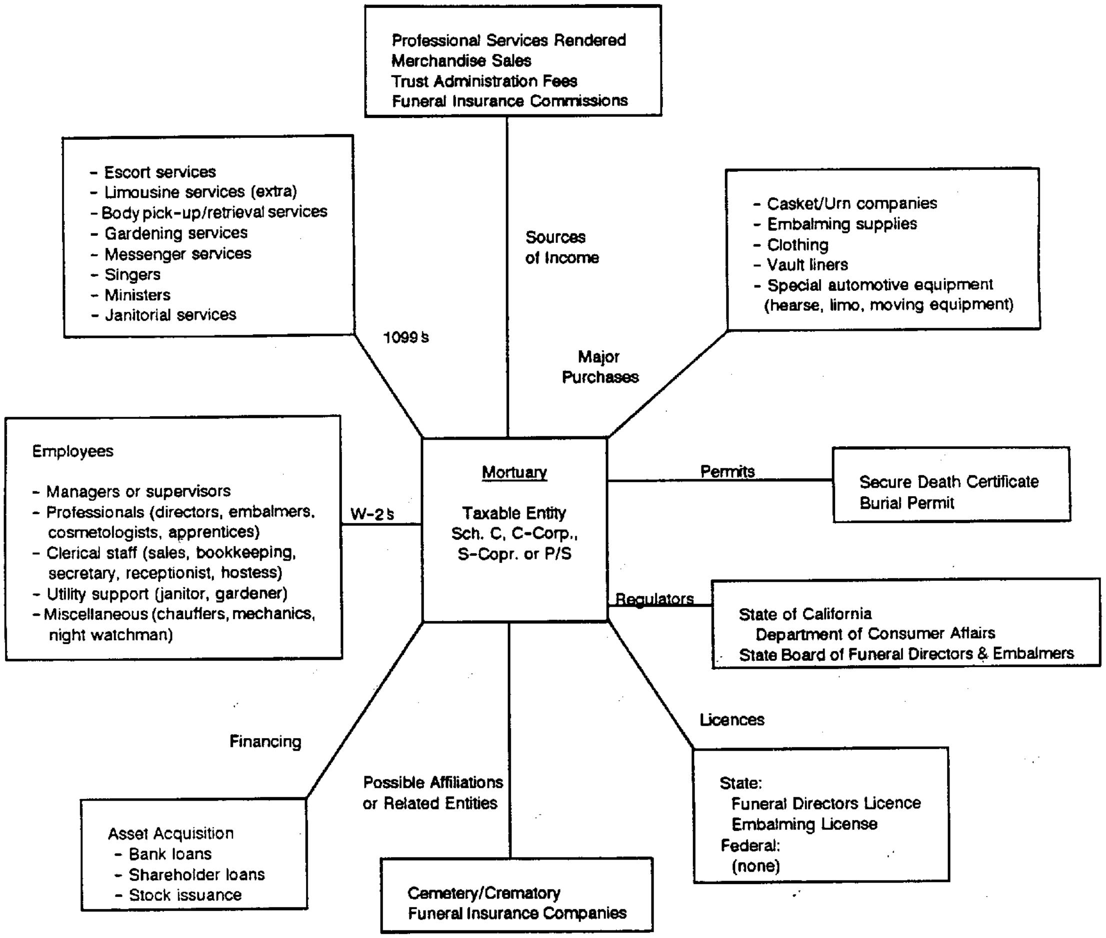
Section 2326 Applications for Cemetery and Crematory Certificates of Authority.

Sets forth the application procedures to receive a Cemetery and Crematory Certificate of Authority. The certificate can be issued to an individual, corporation or partnership.

Article 4. Signs, Contracts, Literature, Etc.
Article 5. Annual Reports
Article 6. Special Care Funds
Article 7. Disciplinary Proceedings

Exhibit 4-3

VARIOUS CHARACTERISTICS OF THE MORTUARY BUSINESS



Note: Mortuaries and Cemeteries were found to be separate entities, although they may be related entities.

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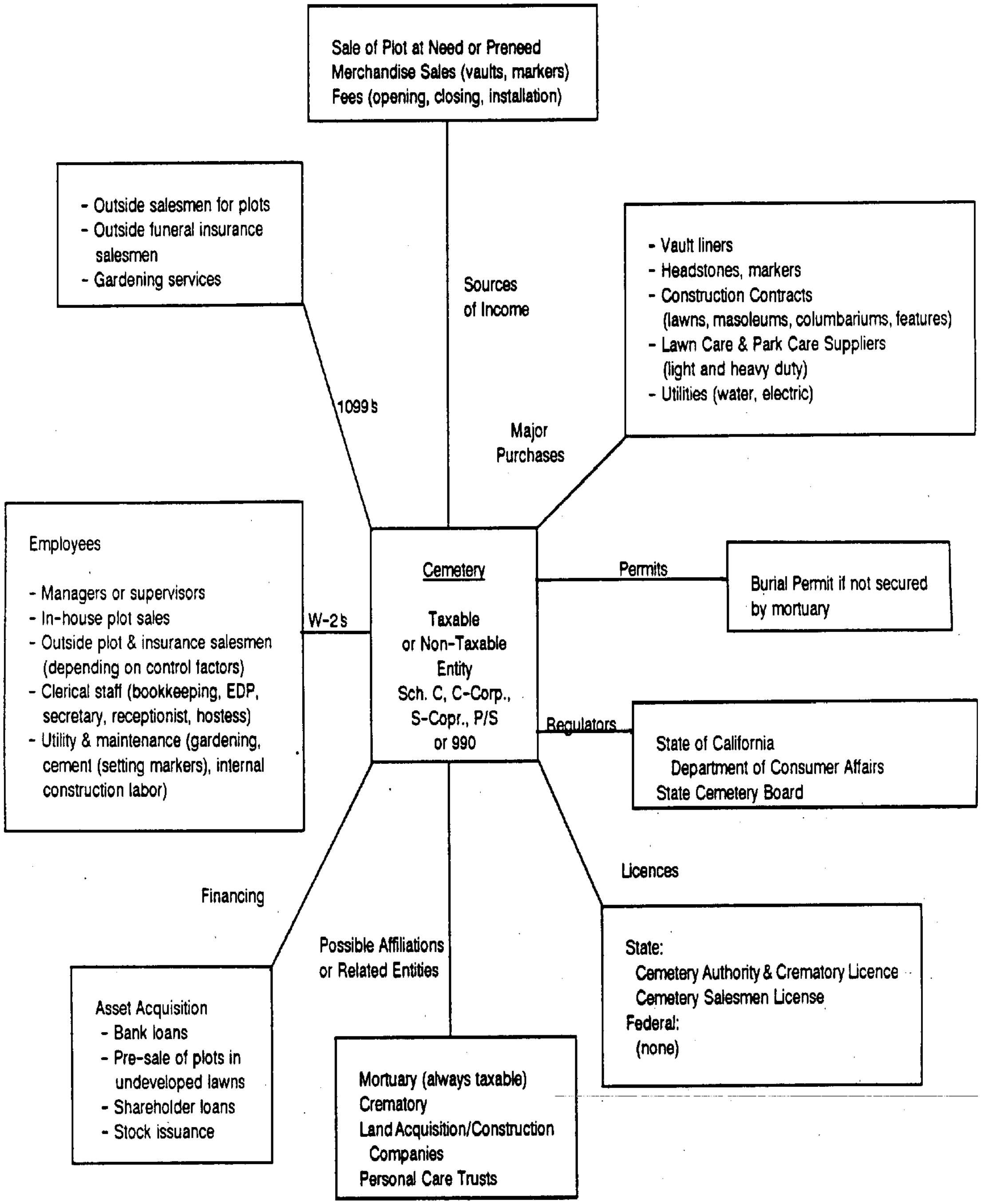
Exhibit 4-4

VARIOUS CHARACTERISTICS OF THE CEMETERY BUSINESS



Note: Mortuaries and Cemeteries were found to be separate entities, although they may be related entities.

Section 5

INTRODUCTION TO THE AUDIT

GENERAL

(1) As with any examination, pre-audit techniques set forth in the Audit Technique Handbook for Internal Revenue Agents (IRM 4231) can be applied to the examination of all mortuary and cemetery returns. Agents should review these guidelines.

(2) It was found during our examination that most of the tax returns in the industry are prepared by CPA firms or law firms. Agents conducted the audits with shareholder/officer or outside accountants on smaller audits and company personnel of larger companies such as controllers or members of their staff and tax department. Outside accountants and attorneys would generally attend the opening conference, be called upon if specific difficulties arose, and generally discuss the proposed adjustments.

(3) The availability and condition of the records as well as the cooperation of the taxpayers was generally found to be very good.

USE OF SPECIALTY GROUPS

Agents should recognize the need for the use of the following specialization services of the IRS as early as possible so as to allow the specialized agent as much time as possible to complete any required audit reports and avoid holding up the closure of the case.

(1) Engineers - Form 5202, Request for Engineering Services should be used to request services when any complex or significant engineering issue is noted on the return. Engineering services were utilized during the examinations to determine the reasonableness of the rent charged by a tax exempt cemetery to its wholly owned taxable subsidiary which was a mortuary and to determine the fair market value of a mortuary sold as a going concern including the value assigned to goodwill and covenant not to compete.

(2) Computer Audit Specialist (CAS) - Where the volume of records exists and a statistical sample is deemed useful, the agent should contact his CAS after consultation with his group manager.

(3) International Examiner (IE) - Form 2962 Foreign and Domestic International

Entity Transaction Report and Referral Form should be submitted by the agent at the earliest possible point in the audit when the agent can ascertain that the company under audit is engaged in business outside the United States directly or indirectly through related controlled or controlling affiliates (see IRM 42(10)4). Since the issues and transactions may be complex, it is important that the agent try to identify as many of the offshore entities as possible when submitting his referral (Questions on Schedule J of the corporate return will generally alert the agent to related foreign entities, however the company should still be questioned as to their existence).

If possible copies of the following should be attached to the referral:

a) Tax return under examination, or if voluminous pertinent pages. (Pages 1-4 of the corporate 1120)
b) Form 5471 - Information Returns with Respect to a Foreign Corporation
c) Form 1116 - Computation of Foreign Tax Credit - Individual
d) Form 1118 - Computation of Foreign Tax Credit - Corp. Any foreign tax credit claimed on the return should be noted.
e) Form 5713 - International Boycott Report
f) Any rulings the taxpayer has received under Code Section 367

(4) Employment Tax Specialists - Should unusual or extraordinary problems appear in the employment tax area, a referral should be made through agent's group manager.

(5) Employee Plans/Exempt Organizations (EP/EO) - Some larger tax exempt cemeteries will have wholly owned mortuary operations which are taxable entities. As part of the examination the agent should inspect the exempt organization return and review the allocations of expenses between the exempt and taxable entity. Should any transaction come to the agents attention which may affect the exempt status of the cemetery an E/O referral should be made through agent's group manager. The agent may also wish to have the exempt organizations return reviewed by the E/O group and determine when the last audit of the cemetery by E/O was performed and what the results were.

PENALTIES

During and at the conclusion of every examination it is the agent's responsibility to consider the application of penalties to be assessed if the circumstances so dictate. As every agent is aware, Congress has now armed the Service with many different penalties to insure compliance with the tax laws. Each district or regional office of the Service has given training classes and issued material explaining the application of each of the numerous penalties available. Agents should refamiliarize themselves with the various penalties and apply them when deemed necessary.

In addition to the application of penalties against the taxpayer the agent should also be aware of the following:

1) The Returns Preparer Program - Procedures outlined at IRM 4297.4 should be followed. In the Los Angeles district CED-19 should also be reviewed.

2) Referrals to the Director of Practice - In the Los Angeles district CED-27 should be reviewed.

The District Penalty Coordinators should be contacted if any questions arise.

INITIAL APPROACH TO AUDIT - PRE-AUDIT AND INITIAL INTERVIEW

Pre-Audit

This paper covers the mortuary and cemetery business each being specialized in its own respect. However some general suggestions for approaching the audit are summarized here. At the time of initial contact with the taxpayer or taxpayer's representative, the agency should attempt to set an appointment for an initial interview of the taxpayer. The agent should request items which should be made available prior to the initial interview. Records to be made available at the initial interview are noted below. While these items can be discussed with the taxpayer or representative on the telephone, they should always be followed up with a document request.

(1) An agent is generally assigned a current year of a company to examine. This year, when isolated, may not indicate unusual items the return may contain. If possible, when the initial contact with the taxpayer is made, the agent should attempt to have the taxpayer or taxpayer's representative send copies of:

   (a) Prior and subsequent year returns. A spread sheet comparison of the following can be made prior to the initial interview with the taxpayer:

      1) Gross Profit Percent
      2) Comparison of changes in income and expense accounts and balance sheet accounts from year to year.

   (b) Copies of majority shareholders and/or corporate officers returns for inspection.

   (c) Copies of any other related entity returns noted on inspection of the return under audit.

(d) If the taxpayer has been previously audited, secure copies of the prior audit reports. This may include federal, or state tax audits.

(e) Determine where the examination will be performed. If it is anywhere but the company, the agent should still require a tour of the operation. The initial interview should be with the owner or a corporate officer with detailed knowledge of the company's financial affairs.

(2) Items which should be made available at the initial interview include:

(a) Company books and records. A "walk through" of the books at the conclusion of the initial interview may be helpful if the agent is to begin the audit at that time. This will help the agent understand the system and determine if all the books and records are available to begin the examination. The books for a small mortuary were found to be easily understood, however, the larger mortuaries had complex systems which required a roadmap.

(b) Chart of accounts.

(c) Complete year end adjusted trial balance grouped to the tax return.

(d) Year end adjusting journal entries (company and CPA).

(e) Certified audit report (if any) covering the year to be examined.

(f) If the company is to have a representative handle the examination, a Power of Attorney should be completed by the taxpayer. The agent should review the power when received to determine that it is correctly completed by the taxpayer (dated, proper years and returns set forth, etc.).

(g) If the company is a corporation, the corporate minute book encompassing at least five years, and the stock ledger book.

(h) If the company is a corporation, explanation and computation of all Schedule M-1 adjustments. If the company is not a corporation, an explanation of any differences between book and taxable income will still be necessary.

Review of the Schedule M-1 adjustments will:

1) Inform the agent how the company treated various income and expense items differently for tax and book purposes. These differences

may be timing differences as to when an income or expense item is shown for book and tax purposes such as state income tax liability, or may be permanent such as the non-deductibility of federal taxes, life insurance on officers.

2) Inform the agent whether items found during the examination of various accounts have or have not been excluded from the totals on the tax return. Often, if the company has not given the agent a trial balance which is grouped to the tax return, it can be quickly done by review of the Schedule M-1 adjustments.

The schedule M-1 is a major source of adjustments on all corporation returns since it illuminates the difference between book income and taxable income.

(i) Copies of the corporation payroll tax returns 940 and 941's for inspection. These returns can be requisitioned or data base secured if audit is deemed necessary during the audit.

Copies of state employment tax returns (Calif DE-3).

(j) Copies of W-2's, W-3 Transmittal, W-4's, 1099's and 1096 Transmittal (Form 4802 or 4804 for magnetic tape) for the year under examination.

(k) Filed copies of Forms 8300, Form 5500 (Pension/Profit Sharing). Form 8300 compliance checks were done on the mortuaries and cemeteries examined and no changes were proposed.

Once the initial interview has been conducted additional specific document requests can be issued.

INITIAL INTERVIEW

The initial interview with a small to medium mortuary or cemetery was usually held with the company owner and CPA, while interviews with the larger companies were held with a corporate officer in charge of financial affairs, controller and CPA. The initial interview should strive to gain as much information as possible and should set certain standards of performance to be expected from the company and/or its advisors. This will hopefully make the audit progress more smoothly and efficiently. Once the initial interview has been conducted, specific document requests can be issued. The questions below are separated into general questions and those pertaining to mortuaries and cemeteries. (Note: These are recommended questions. The list is not all inclusive. The examiner should use his/her judgement when preparing for and conducting the interview.)

General Questions:

1) Is the company involved in the mortuary business, cemetery business or both? If the company operates both, is the cemetery a taxable or tax exempt entity?

   If a tax exempt cemetery exists, determine how the mortuary and cemetery are related and request a copy of the exempt organization Form 990 for inspection.

   If a taxable cemetery exists determine how the mortuary and cemetery are related and request a copy of the return not in your possession. The entities are probably separate companies.

2) How long has the company been in business?

3) Have the owner or officer give you a brief history of the company and how it has evolved to its present status.

   Have the owner give you an overview of what the operation of the company entails, with emphasis on what services and materials are provided, before asking particular questions noted below. Many businessmen are more than willing to explain in detail the operation of their business and will provide the agent with a better starting point for asking questions about particular areas noted below. After the company's explanation, the agent can expand and explore further additional areas as he deems necessary in order to understand the operation of the company.

4) How many locations does the business have?

5) Has the company acquired any other businesses or sold any parts of its businesses in the last three years including subsequent years? If so, additional probing should be done.

6) Has there been a change in the form of the business during the year (incorporation, change in ownership, reorganization, etc.)? Schedule M-2 on a corporation return should be reviewed. It will show any current dividend distribution, stock redemptions. If any changes are noted, secure explanation and note to request contracts pertaining to changes in ownership, reorganization, etc.

If the Company is a Mortuary:

1) Is it the company's normal practice to have a contract signed for every funeral?

2) Is payment required prior to the service or is it billed?

3) If billed, what are payment terms and is there an invoice/statement issued?

4) What internal record is kept of funeral services (funeral book, card file, computer files)? Request this file to compare to the sales journal later.

5) Does company accept insurance checks for payment of services? If so, and the check is greater than the funeral bill and a payment to the heirs is made, have the accounting treatment explained so that it can be tested later.

6) Does the company make cash advance payments for customers which are recouped through the final billing to the customer? If so what items are included and how is the accounting reflected on the books? (The treatment on the books can be reviewed later to determine that no double deduction occurs.)

7) Does the company offer pre-need trust plans for funeral services?

   Have the company explain how their funeral trusts operate.

   Who is the trustee?

   Does the company receive any trustee fees while the trust exists?

   Have company explain when and how the pre-need trust income is recognized for tax purposes.

   If the trust contains more money than the funeral bill, is the excess returned to the trust or the heirs?

8) Does the company offer funeral insurance?

   If so, what companies is it offered through and how does it operate? The company should have a brochure which it provides to potential customers explaining the plan as well as a contract and information package for the company explaining how they will be compensated for offering the insurance. The mortuary may have a separate company set up for this purpose.

   Have the company explain how the insurance is sold.

   If an outside sales force is used, are they paid outside commissions or salaries? (Factors relating to control and discussion of employee vs. independent contractor can be deferred until the books have been reviewed.)

9) Does the company offer any other pre-need funeral arrangements?

10) Are the following items company owned and operated or are they contracted out?

    1) Flower shop
    2) Escort service
    3) Limousine service
    4) Body pick up service

11) What items does the company inventory? Is the company familiar with Section 263(a) as it pertains to inventory? Be prepared to explain.

12) Does the company provide living accommodations for any officer, shareholder or employee? If so, to whom, where and in what capacity? Dividend, salary and employment tax issue can be further developed later.

13) What are the names and job titles of relatives working in the business?

14) If the company owns limousines, are they rented out to other funeral homes? For any purposes other than funerals?

15) If the company is owned by a tax exempt cemetery or is related to a taxable cemetery, are there allocations of various costs such as advertising, utilities, officers salaries etc. If so, the company can be informed they will be requested at a later date. The related cemetery should also be reviewed.

16) Company can be advised that the agent has questions regarding internal control which will be discussed with the controller or other designated persons once the books have been provided.

    See Exhibit 5-1 Internal Control Questionnaire.

    It is recommended that before asking the internal control questions, the agent should ask the controller to provide an in-depth explanation of the internal control the company has in place. This would entail a step-by-step description of how transactions like sales, purchases, etc. are recorded from the point of origin to final bank deposit or payment. It would be helpful if the agent has reviewed the internal questions beforehand to prepare for any questions the controller might have. Afterwards, the questionnaire may be reviewed to check on any items which may have been passed over or need clarification.

If the Company is a Taxable Cemetery:

1) Does the cemetery sell grave sites on an as-need and pre-need basis?

2) How are each of these types of sales reported for tax purposes (method of accounting for the sales and costs)?

3) Does the company maintain an internal list of all burials and cremations made during the year? If so, have the taxpayer provide the list to trace to the sales journal.

4) Is the cemetery an endowment care or non-endowment care cemetery?

   If the cemetery is an endowment care cemetery, in whose name is the endowment care fund held (trustee or company)? If company, interest earned on the fund should be income to the company.

   If there is a separate endowment care trust, who is the trustee? The endowment care trust return can be requested at a later date.

   Does the cemetery receive an administration fee from the fund?

   Does the trust maintain the cemetery directly? If not, is the income earned by the fund distributed to the cemetery to be used for care and maintenance?

   What items is endowment care collected for (Plot, marker)?

   Did the company make any voluntary contributions to the fund during the year? How are these contributions recorded on the books?

   Review Endowment Care Fund discussion in Section 7.

5) Does the company accept insurance checks for payment of cemetery items?

   If so, and the check is greater than the bill and the excess is paid to the heirs, have the taxpayer explain how these checks are accounted for in the books.

6) What items does the company inventory? Is the company familiar with Section 263(a) as it pertains to inventory? Be prepared to explain.

7) Does the company make cash advance payments for customers which are recouped through the final billing to the customer? If so, what items are included and how is the accounting reflected on the books? The treatment on the books can be

reviewed later to determine that no double deduction occurs.

8) How are pre-need grave sites sold? If sold by an outside sales force, are they considered employees or commissioned salesmen? Factors relating to control and discussion of any employee vs. independent contractor can be deferred until the books have been reviewed.

9) Does the company provide living accommodations for any of the officers, shareholders, or employees? If so, to whom, where and in what capacity?

10) Does the cemetery operate a crematory? If so, State required reporting forms stating the number of cremations can be requested later.

11) Does the company allow the occupation of a grave prior to its being paid in full? (If not, there should be no bad debts.)

12) If the company is related to a mortuary, are there allocations of various costs such as advertising, utilities, officers salaries etc. between the companies? If so, the company can be informed they will be requested at a later date. The related mortuary should also be reviewed.

13) What are the names and job titles of relatives working in the business?

14) Are any of the shareholders related? If so, how?

15) Company can be advised that the agent has questions regarding internal control which will be discussed with the controller or other designated persons once the books have been provided.

    See Exhibit 5-1, Internal Control Questionnaire.

    It is recommended that, before asking the internal control questions, the agent should ask the controller to provide an in-depth explanation of the internal control the company has in place. This would entail a step-by-step description of how transactions like sales, purchases, etc. are recorded from the point of origin to final bank deposit or payment. It would be helpful if the agent has reviewed the internal questions beforehand to prepare for any questions the controller might have. Afterwards, the questionnaire may be reviewed to check on any items which may have been passed over or need clarification.

<u>The following items should be considered to help speed the flow of information from the taxpayer</u>:

1) Who will the agent issue document request to within company and who will be responsible for furnishing the agent with the requested information?

2) Who will the agent have access to for answers to questions as to the operation of the books? Will this person be readily available until the agent understands the accounting system?

3) Is the individual that the agent is to work with familiar with the books and operation of the company, and will they be accessible to the agent on a reasonable basis or should weekly meetings be set up in advance to answer outstanding questions (larger audits)?

4) Do all general questions regarding company operations have to be submitted as part of the document requests or is the company willing to be informal with regard to general explanations needed? If the company wants all questions to be included in the document requests, these could become lengthy and agent should give additional consideration to their organization. The company should also be informed that answers to questions should be through meetings with individuals who have first hand knowledge of the facts and not just "canned" statements to the agent which result in many additional questions. Document requests should be organized in such a way that the agent knows when documents were requested or questions asked, who the taxpayer said the answer was to come from, what work paper it refers to, and whether or not it was answered. Work papers should be indexed to the document requests so that the particular work paper can be located quickly, should the need arise.

DOCUMENT REQUESTS

Document requests should be issued using Form 4564. The form is self-explanatory. While organization of document requests on a small case may not be a problem, cases of increased size and complexity require some planning and organization. Since the document requests issued by the agent will probably have to be reviewed with company personnel many times during the examination, the agent should give consideration as to how the requests will be issued. The agent should at least have a separate document request for each account examined, and as mentioned elsewhere, the request should be indexed to the Work papers (the form 4564 has a space for SAIN numbers discussed below). Agent should be able to quickly determine which items are open and retire the completed requests to a separate section of the document request file. Form 5699, Information Document Request Log, should be used to index the document requests issued.

SAIN (STANDARD AUDIT INDEX NUMBERS) WORK PAPERS

In organizing the Work papers agents may consider the use of the SAIN work paper numbering system and use of the SAIN work paper lead sheets. This work paper numbering system is used by large case examination groups throughout the Service and should be easily attainable in hard copy or data disk form. These Work papers use a simple numbering system which are tied into the line numbers of an item on the tax return. Once properly implemented, a work paper can be universally identified within the Service as to the account on the tax return it refers to.

Comparison of changes in the income and balance sheet accounts called for above will generally alert the agent to items which merit particular review on a case-by-case basis, be it inventory changes, insurance expense, travel and entertainment, etc. The SAIN Work papers, in addition to the numbering system, give suggested discretionary audit steps to be applied in the verification of any line item on the tax return. Use of the discretionary audit steps in conjunction with the agents existing skills, initiative and judgment as well as suggested audit techniques for income and balance sheet accounts set forth in the Internal Revenue Manual, should aid in the analysis of verification of any item which the agent may wish to examine which is not specifically covered by any other section of this guide.

Exhibit 5-1

SAMPLE: INTERNAL CONTROL QUESTIONNAIRE FOR SMALL BUSINESSES

Taxpayer Name: ___________________________

Period(s) under examination: ___________________

	Name and Position	Date
Taxpayer's personnel consulted in connection with the preparation of this questionnaire:		
	________________	______
	________________	______
	________________	______
	________________	______
	________________	______
	________________	______

Prepared by: ___________________ __________

(REVENUE AGENT) Date

This sample internal control questionnaire may be used in total or on a selected basis when appropriate as determined by the examining agent in the review and evaluation of internal control policies and procedures.

Each question is to be answered. All "no" answers should have a written explanation.

It is recommended that before asking these internal control questions, the agent should have the controller provide an in-depth explanation of the internal control the company has in place. This would entail a step-by-step description of how transactions like sales, purchases, etc. are recorded from the point of origin, through final bank deposit or payment. It would be helpful if the agent reviews the internal control questions beforehand to prepare for any questions the controller might have. Afterwards, the questionnaire may be reviewed once more to check on any items which may have been passed over or need clarification.

<u>Answer</u>

	Yes	No	N/A	Date	Comments/Reference to W/P Numbers
1) Is the general ledger kept up to date and balanced monthly?					
2) Are internal financial statements prepared and are they reviewed by an owner or an officer?					
3) Are the bank accounts reconciled monthly?					
4) Are the journal entries approved and adequately explained?					
5) Are all employees who are involved in record keeping or custody of assets, or in some other position of trust, adequately bonded?					
6) Are all employees required to take annual vacations?					
7) Are personal transactions of management completely segregated from the business?					
8) Is consistency of account classification provided for by the use of a chart of accounts?					
9) Is the insurance coverage carried by the client periodically reviewed for adequacy?					
10) Are all the bank accounts in the name of the client recorded on the books?					

Answer

Cash Receipts

	Yes	No	N/A	Date	Comments/Reference to W/P Numbers
1) Is the mail opened by someone other than the bookkeeper?					
2) Is the listing of mail receipts prepared by someone other than the bookkeeper?					
3) Is the listing reviewed and reconciled to the cash receipts journal by someone other than the bookkeeper?					
4) If cash registers or other mechanical devices are used in recording transactions, are cash register tapes saved and reconciled to the cash receipts journal?					
5) Are cash receipts deposited intact daily?					
6) Is a detailed duplicate deposit slip prepared and receipted by bank?					
7) Are recorded cash discounts and allowances periodically reviewed by an officer or owner?					

Answer

Cash Disbursements	Yes	No	N/A	Date	Comments/Reference to W/P Numbers
1) Are all disbursements made by prenumbered checks (except for small items paid out of Petty Cash)?					
2) Is a check protector used? Who is authorized to sign checks?					
3) Is the bookkeeper prohibited from signing checks?					
4) Is the supply of unused checks controlled?					
5) Is check-signing in advance prohibited?					
6) Are supporting documents approved for payment and canceled when paid?					
7) Are voided checks retained and accounted for?					
8) Are petty cash disbursements evidenced by supporting vouchers?					
9) Are these supporting vouchers approved?					
10) Are bank reconciliations prepared by someone other than the bookkeeper?					

ADD APPROPRIATE STEPS

Answer

Accounts Receivable & Sales

	Yes	No	N/A	Date	Comments/Reference to W/P Numbers
1) Are monthly statements mailed to customers?					
2) Are they reviewed by someone other than the bookkeeper before mailing?					
3) Is the customer's subsidiary ledger reconciled monthly to the C/L?					
4) Is an aged listing of A/R prepared monthly for review by an officer or owner?					
5) Are all allowances and write-offs approved by an officer or owner?					
6) Are customer orders and credit approved by an officer or owner before acceptance?					
7) Are work orders or job numbers, sales invoices, and credit memos prenumbered and controlled?					
8) Is there a prescribed follow-up procedure for collection?					
9) Are pricings, extensions, and footings on sales invoices independently checked?					

ADD OTHER APPROPRIATE STEPS

Notes Receivable & Securities	Answer Yes	No	N/A	Date	Comments/Reference to W/P Numbers
1) Are notes and investment certificates adequately safeguarded?					
2) Is the custodian of the notes and investment certificates someone other than the bookkeeper?					
3) Are notes and securities in the name of the client?					
4) Are sales and purchases of securities approved by an officer or owner?					

ADD OTHER APPROPRIATE STEPS

Answer

Inventory

	Yes	No	N/A	Date	Comments/Reference to W/P Numbers
1) Is the paperwork reflecting the movement of inventory items controlled and accounted for to prevent errors and irregularities by establishing accountability for inventories which should be on-hand?					
2) Is the flow of paperwork synchronized with the physical movement of goods?					
3) Are the perpetual inventory records maintained? If so, for what items?					
4) a. Are physical counts made at least once, yearly, of all inventory items? b. If perpetual inventory records are maintained, are physical counts reconciled with recorded amounts?					
5) If costs and inventories cannot be determined from regular accounting records without taking physical inventories, is there any independent check on the reliability of periodic physical inventories? That is, is there any independent means of establishing with approximate accuracy the amount of items that should be on hand?					

(Inventory continued on next page)

Answer

Inventory (continued)

	Yes	No	N/A	Date	Comments/Reference to W/P Numbers
6) Where the taxpayer has merchandise on-hand which is not his or her property (consignments), is it physically segregated and kept under strict accounting control?					
7) Are the following classes of inventories, if any, under accounting control? a. Consignments to other? b. Materials or merchandise in warehouse? c. Merchandise shipped on memorandum or approval?					
8) Are the inventories periodically reviewed for the purpose of determining the extent of slow moving, obsolete items?					
9) Are physical inventories taken by employees other than the storekeepers and persons responsible for maintaining perpetual inventory records?					
10) Are inventories stored in an orderly systematic manner to facilitate handling and counting and to prevent deterioration?					
11) Are there safeguards against issuance, removal, without proper requisitioning or recording?					

(Inventory continued on next page)

	Answer				
	Yes	No	N/A	Date	Comments/Reference to W/P Numbers
Inventory (continued)					
12) Are there procedures for counting, inspecting, and reporting incoming materials, merchandise, and supplies?					
13) Is there written approval by a responsible employee of adjustments of perpetual records to physical counts?					
14) Is the physical layout of plant, storerooms, etc. such as to minimize possibilities of theft and pilferage by employees and others?					
15) Are the key positions for inventory handling and recording occupied by persons who do not perform any duties in connection with the billing of sales or vouchering of purchases?					

ADD OTHER APPROPRIATE STEPS

Answer

	Yes	No	N/A	Date	Comments/Reference to W/P Numbers
Property, Plant & Equipment 1) Are purchases, sales and retirements approved by an officer or owner?					
2) Are there physical safeguards against theft or loss of tools and other movable equipment?					

ADD OTHER APPROPRIATE STEPS

Answer

Purchases & Trade Payables	Yes	No	N/A	Date	Comments/Reference to W/P Numbers
1) Are pre-numbered purchase orders used, and are they approved by an officer or owner?					
2) Are pre-numbered receiving reports used, compared and attached to purchase orders and invoices?					
3) Are vendors' monthly statements compared and reconciled to recorded invoices?					
4) Is monthly schedule of accounts payable prepared and reconciled to G/L control and is it reviewed by an officer or owner?					
5) Are disbursements by check made from approved invoices only?					
6) Are the clerical accuracy, prices and terms of vendors' invoices verified?					
7) Is purchasing function segregated from accounting and receiving functions?					

ADD OTHER APPROPRIATE STEPS

	Answer				
	Yes	No	N/A	Date	Comments/Reference to W/P Numbers
Payroll					
1) Are employees hired by an officer or owner?					
2) Are initial rates and changes in rates authorized by an officer or owner?					
3) Are terminations authorized by an officer or owner?					
4) Is there a clock or other method of recording time?					
5) Does an officer or owner approve overtime?					
6) Are employees paid by check?					
7) Does an officer or owner sign payroll checks?					
8) Are unclaimed payroll checks controlled?					
9) Is a separate payroll bank account maintained, and is it maintained on imprest system?					
10) Is the payroll bank reconciliation prepared by someone other than the bookkeeper?					

(Payroll continued on next page)

	Answer				
	Yes	No	N/A	Date	Comments/Reference to W/P Numbers
Payroll (continued) 11) Are advances approved by an officer or owner and is consideration given to advances when payroll checks are prepared?					
12) Are payroll tax deposits made in conformity with applicable Federal and State regulations?					

ADD OTHER APPROPRIATE STEPS

Section 6

MORTUARIES

GENERAL OVERVIEW

Small to medium-size companies derive the bulk of their business within and around the community in which they are located. Because funerals are not the type of service which most prospective clients think about in advance, when death occurs, families tend to go to the funeral home which is most accessible or closest to them. The memorial counselor is the individual who deals with the survivors initially and throughout the funeral process.

Due to the client's emotional state and vulnerability upon commencement of the funeral arrangements, the industry is regulated by federal and state agencies (see Exhibits 4-1 and 4-2) to ensure that customers are protected from unscrupulous operators. The Federal Trade Commission (FTC) and the State Board of Funeral Directors requires every funeral director, before entering into a contract with any person, to provide a printed list enumerating the services offered and their respective prices.

Whether a mortuary is owned by an exempt or nonexempt cemetery, it will always be taxable. The operation of a mortuary includes the following:

1) Pickup of the deceased from their home, hospital, convalescent home, etc.

2) Preparing the deceased for viewing and burial and conducting funeral services.

3) Delivery of the deceased to the cemetery or other disposal service (i.e. Neptune Society).

4) Merchandising of caskets, vault liners, flowers, burial clothing, memorial books and folders, etc.

Articles read in industry magazines indicate that the mortuary industry is generally thought to be in a period of consolidation. Transition is taking place from individual, independently owned funeral homes to larger, multi-site operations. Some of these operations are multi-state in size.

Most of the funeral homes examined, which ranged from small corporations to some of the larger mortuaries in the Southern California area, were either family-owned or closely-held enterprises. With individual proprietorships, the owners are usually the licensed funeral directors. The smaller funeral homes had numerous family members employed in the business.

The total number of death certificates filed in Los Angeles County showed that death rates are somewhat stable in the absence of a major catastrophe.

	1988	1989
Los Angeles County	59,612	59,622
Long Beach	4,906	4,748
Pasadena	1,724	1,694

Old age is the leading cause of death, and because the holiday season seems to have an adverse effect on older people, the mortuary business is busiest during the months of December and January.

Financing

The financing of improvements made to mortuary assets (building facilities) were through bank loans or internally generated funds.

Most mortuaries required full payment for mortuary services at the time they were rendered. Clients paid by cash or assignment of life insurance benefits to the mortuary (if no pre-need funeral trust has been set up). Financing of funerals did not appear to be a prevalent practice by mortuaries. One mortuary, however, did allow payment for funerals to be paid on installments. Interest was charged on the unpaid balance. The taxpayer properly included the sale in income at the time services were rendered and the interest as it was earned.

Forms Filed

Death Certificate

Generally, the death certificate is prepared and filed by the mortuary. In California this is filed with the local office of the state health department except for the cities of Pasadena and Long Beach which require the death certificates to be filed with them if this is where the deceased died.

The certificate is eventually forwarded by the health department to the Los Angeles County Hall of Records where it is kept on microfilm. The original is then transferred to the California State Registrar Office (Office of Vital Statistics) for final keeping. Items of interest to the agent are as follows:

Type of disposition.
Name and Address of Place of Disposition.
Date of Disposition.
Name of Funeral Director (this is generally the name of the funeral home).

Burial Permit

The mortuary also generally secures the burial permit from the health department. If the mortuary is unable to obtain the permit, the cemetery will secure one. The burial permit is forwarded with the deceased to the final resting place. It is the responsibility of the cemetery to file the permit with the State Registrar Office of the District in which disposition occurs. All other copies of the permit are destroyed approximately one year later according to the burial permit.

Pre-Need Trust and Funeral Insurance

Although most of a funeral home's clients pay for the funeral services at the time they are rendered, there is a growing segment of the population which prefers to make all the funeral arrangements themselves and not leave it to their families. This arrangement assures the client that in the event of his or her death, his or her survivors are freed from the financial and emotional burden of making decisions about funeral arrangements. This is encouraged by funeral homes because it virtually assures them of the future business.

These pre-need arrangements pertain only to the funeral service and not the interment property. The pre-need sale of interment property is covered under the cemetery section of this guideline. The pre-need arrangement of funeral services is achieved through the following methods:

1) Individual funeral service trusts set up through banks or S&L's.

2) Individual or mutual funeral service trusts set up through mortuaries.

3) Funeral insurance.

Individual Funeral Service Trusts

The future customer generally prices the current cost of the funeral service that he or she desires at the funeral home of his or her choice. An individual trust is then set up in the individual's name at a local bank. Deposits into the trust may be made in lump sum or periodic payments. The funeral home is shown as the beneficiary of the trust. The trustee (bank) is required to report all interest earned on the trust to the IRS and the customer by filing a Form 1041. Trustees of grantor trusts are also required to report items of income, deduction, and credit on an attached statement. The interest earned by the trust is generally felt to offset inflation. The grantor may terminate or change the beneficiary of the trust at any time. There is no trust return filed by the bank.

The client signs a pre-need contract with the funeral home of his or her choice. This contract may call for the funeral home to provide all preselected items which pertain to the funeral service at the time needed regardless of the future cost. However, it is more common for only the price of certain items of the funeral to be guaranteed (those less affected by inflation) while others are open to future price increases (see lists of guaranteed and non-guaranteed items under funeral insurance below).

The initial or periodic payments made into the trust along with interest earned is applied against the total future actual price of the funeral (guaranteed plus non-guaranteed items). If there is a balance due, it would normally be paid by the estate or relatives. If the funeral trust payment exceeds the funeral cost, the excess amount is refunded to the estate.

This type of pre-need arrangement is exempt from the provisions of the Business and Professions Code (Division 3, Chapter 12, Article 9 (The Shor Act)) since the money put into the bank or S&L is controlled by the client and not the mortuary. From checking with local banks it does not appear that the banks charge the clients a cancellation fee. If a cancellation occurs, the trustee has to notify the funeral home so their records can be updated. When the client dies and funeral services have been provided, funeral homes (in the State of California) are required to send a copy of the death certificate to the trustee so that funds can be released to pay for the funeral.

The setting up of the trusts would not result in any income until a death occurs and the services are provided.

Mutual Funeral Service Trusts

These trusts operate in similar fashion to the single trusts in that the client meets with the mortuary and selects the items to be a part of his or her funeral service. A payment is made to the trust (operated by the mortuary) which is invested in bank certificates of deposit or money market instruments. The client owns a portion of the value of the trust at any particular time similar to the ownership of a mutual fund. The mortuary may guarantee the price of all items or only a few items which will be covered by the client's share of the funds value. At the time of need the client's portion of the fund will be used to offset the total bill. Any additional funds would have to be contributed by the estate or family or items of lesser value may be substituted.

Since this trust is established with the mortuary it comes under the rules set forth by the State of California Funeral Directors and Embalmers Law. The state law mandates that all payments received for pre-need funeral arrangements should be held in trust until the contract is fulfilled. Under provisions of the law, when a client cancels the trust the mortuary may charge a revocation fee which is limited to the lesser of 10 percent of the corpus or the trust's current year's earned income. An Administration fee may be charged by the trust limited to the lesser of four percent of the trust balance at year end or the trust's current year's earned income. The mortuary would report as income any administration fees or revocation fees charged. However, no income would be recognized on setting up of the client's interest in the trust until such time as the services are provided. No actual trust return is filed. The trust would be required to submit Forms 1041 to all trust participants for income earned.

Based on articles read in industry publications, it appears that most acts of fraud committed by funeral homes appear to have involved pre-need funds. Some mortuaries have set up their own trust funds and made unauthorized use of the funds without reimbursing the trust. Some mortuaries who have used third-party trustees, have declared their clients dead (some states do not require death certificates) when in fact they are alive, and then withdrawn the funds illegally.

Funeral Insurance

Funeral insurance is usually offered by mortuaries which become licensed insurance agents and through their licensed life insurance salesmen solicit life insurance policies specifically structured to pay for funeral services. The actual life insurance company is usually a separate non-related entity. The business will generally operate as follows:

a) The client meets with the licensed life insurance salesman and selects the guaranteed and non-guaranteed funeral goods and services. The salesman may be an employee or independent contractor of the mortuary depending on the control factors present.

The guaranteed items to select from would include such items as the following:

1) Commodities/Services

- Casket
- Memorial Marker
- Urn
- Memorial Books
- Clothing
- Opening and Closing
- Outer Burial Container
- Flowers
- Acknowledgment Cards
- Memorial Folders
- Cremation Charge

2) Commodities/Services Fee

- Funeral Coach
- Flower Van
- Family Car
- Utility Vehicle

3) Professional Services

- Traditional Service
- Sanitary Care
- Refrigeration
- Cosmetic and Hair Care
- Services of Funeral Director, Staff and Facilities
- Transferring remains to the mortuary
- Preparation/Care of Remains/Embalming
- Preparation Room
- Use of Viewing Facilities

Facilities

4) Funeral Ceremony

♦ Chapel
Attendants ♦ Grave side Only

Service ♦ Second Service
(Prayer, Rosary)

♦ Gate and Chapel Attendants
♦ Directing Memorial Service

Non-guaranteed items to select from would include the following:

♦ Disposition permit
♦ Minister Honorarium
♦ Vocalist
♦ Transportation
♦ Motorcycle Escort
♦ Death Certificate
♦ Organist
♦ Newspaper Notices
♦ Transfer Case
♦ Sales Tax

b) The client agrees to purchase a life insurance policy marketed through an independent insurance company specifically designed to cover the cost of the guaranteed funeral items. Additional coverage may be added to cover the non-guaranteed items. Payment for the policy may be by a lump sum payment or multiple payments. The policy is assigned to the mortuary to be used as payment for the guaranteed funeral service items.

While the mortuary is not assured of getting the business when the person eventually dies (since the client may relocate and the policy would follow the client) the mortuary receives a commission from the life insurance company for policies put in force during the year as well as from those which have remained in force for more than a year.

The method and manner of commission payment by the insurance companies to the mortuaries will vary depending on the insurance company involved. An example of one of the larger insurance company compensation plans is as follows:

The mortuary receives:

1) Sales commission on individual policies issued - commission is paid on a sliding scale based on the amount of the policy.

2) Marketing allowance - an additional marketing allowance is paid as a percentage of the face value of the policy on a sliding scale based on the age of the client at time of issue.

3) Activity bonus - an additional bonus is computed monthly on a sliding

scale based on the total dollar volume of policies used.

4) Profit sharing commission - an additional bonus percent is paid on each policy as it reaches the annual anniversary dates.

Assuming the taxpayer is on the accrual method of accounting, the above commissions are to be reported as income as earned (upon receipt of the commission statement from the insurance company). Income on the exercise of the policy upon death of the client would of course be recognized at the time the services are rendered.

Payment for the insurance policies can be made in full or over a five- or ten-year plan. The commissions paid above are reduced and reflected in the commission statement if other than the full cash payment is received.

The IRM makes note of mortuaries which sell pre-need services which are paid for by a small weekly fee (10 cents a week) but this kind of arrangement was not encountered in the examinations conducted. However, as noted in the IRM the amounts received would be income at time of receipt, not at time of death of policy holder since it was not put into a trust and there was no restrictive use of the funds.

The various mortuaries audited were offering funeral insurance through the same nationally recognized funeral life insurance company. A review of this life insurance company's brochures, contracts with mortuaries, and discussion of the plans with the mortuaries did not reveal any hidden reserves which were accumulated for the mortuaries to be paid out at a later date. However, should agents examine a mortuary offering funeral insurance, the taxpayer should be questioned as to the operation to acquire an understanding of:

1) Who is the actual insurance contract with? If the client contracts with the mortuary, does the mortuary in turn insure with a larger company?

2) If the actual insurance is through an independent insurance company, obtain a complete explanation of what fees, bonuses, commissions etc. are received (in addition to amounts received on death of the policy holder) and determine if there are any retention or reserve amounts kept by the insurance company on the mortuaries behalf which are to be paid at a later date.

Based on the facts gathered, third party inquiries to the insurance companies may be warranted.

STRUCTURING OF COMPANIES

All mortuaries examined were structured either as C corporations or S corporations. There were no single proprietorships or partnerships examined although several were inspected while making the selection of returns to examine. Some of the corporations started as single proprietorships and evolved into corporations in years prior to those examined.

The larger mortuaries were often related to cemeteries (taxable and exempt) with both entities operating out of the same locations and sharing various personnel, facilities and computer systems. Also, some mortuaries had wholly owned subsidiaries doing business in other related mortuary fields such as insurance and land development.

METHODS OF ACCOUNTING

Since mortuaries maintain inventory, they should account for their income and expenses under the accrual method or a hybrid method of cash and accrual. Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352 (1st Cir. 1970). A hybrid method allows the recording of income and cost of goods sold under the accrual method, but allows other expenses to be recorded on the cash basis. Whatever the taxpayer chooses will be acceptable if it is in accordance with generally accepted accounting principles and is consistently used by the taxpayer from year to year. All returns examined, except for one taxpayer who opted for the hybrid method, used the accrual method. However, the smaller mortuaries accumulated costs to the general ledger through the cash disbursements journal, then adjusted the books to the accrual method by taking into account the beginning and ending bills outstanding.

Prior to the 1986 Tax Reform Act, taxpayers were also allowed to report sales under the installment method. After 1987, dealers in personal or real property are generally excluded from using the installment method for sales or other dispositions. A dealer disposition is one in which personal or real property is sold or disposed in the ordinary course of the business. Unrecognized installment gain (as of 12/31/87) was required to be added to taxable income as an IRC Section 481(a) adjustment under the principles of Rev. Proc. 84-74. The adjustment period is generally four years instead of six years. However, if the adjustment is entirely attributable to the 1987 tax year, the adjustment should all be added to taxable income in 1988. This adjustment will appear on the Schedule M-1 of the tax return.

SUMMARY OF BOOKS

The accounting books and records encountered were not unusual or materially different than other industries. They ranged from informal set of books with very simple accounts to computerized records with complex and elaborate systems of accounts. Some or all of the following records were maintained:

Cash disbursements journal
Cash receipts journal
General journal
General ledger
Purchases journal or Accounts Payable listing
Payroll journal
Sales journals
Trial balance
Card file and/or Sales funeral book

Unusual records maintained were the card file and/or sales funeral book which accumulated all of the data about the deceased such as:

1) When, where and how he or she died.
2) Manner and place of disposition.
3) What the contracted funeral arrangements and the respective prices were.
4) How and who paid the bill. The card file may be filed in alphabetical order, while the sales funeral book (which is a bound book), may be filed by date of death.

General Ledger Accounts

The makeup and type of items included in the Balance Sheet and Profit and Loss accounts were as follows:

Assets

Cash. This may include petty cash, general checking account, payroll account, savings accounts, accommodations account and pre-need trust account (if funeral home sets up its own).

Accounts Receivable. This arises from mortuary sales of services, merchandise, cash advance items and funeral insurance commissions earned. Cash advance items consisted of charges to clients for items such as filing fees for death certificates and burial permits, honoraria to ministers, soloists, hiring of pall bearers, obituaries, transportation of decedent by air or rail, flowers, escort and limousine service. The mortuary does not make a profit from the cash advance charges because arrangements are made for the convenience of and at no extra cost to the client (charges to client are for the exact amount paid or incurred by the mortuary).

It was noted during our examination that the mortuary recorded cash advance items under two different methods as follows:

1) By recording the cash advance items as income and expense as follows:

	DR	CR
Accounts Receivable	500	
Cash Advance income		500

To record the billing of the cash advance items paid for the client (for example escort services)

Cash Advance Expense or Escort Expense	500	
Accounts Payable		500

To record the payable to the escort company

Accounts Payable	500	
Cash		500

To record the payment to the escort company

Cash	500	
Accounts Receivable		500

To record the collection of the receivable from the client

2) By recording the cash advance items as a receivable with an offsetting liability account.

Accounts Receivable (Client)	500	
Cash Advance Liability		500

To record the cash advance due from the client.

Cash Advance Liability	500	
Cash		500

To record the payment of the escort service bill.

Cash	500	
Accounts Receivable		500

To record payment of the cash advance item by the client.

Under both methods of recording the cash advance items the net effect to the mortuary should be zero since the company is not realizing a profit on these items. Under the income and expense method of recording the transaction it is more difficult to determine a discrepancy between what is being reported as income and expense since the income may all be recorded in a common account while the expenses may each have individual accounts such as obituary expense, escort expense, limousine service expense.

It was noted during audits performed that under the accounts receivable and liability method the liability account sometimes developed a debit balance which was offset against the sales account at year end. This was either the result of company paying additional billings (obituary) for which it did not bill the client or including unrelated items in the liability account.

Intercompany Account Receivable. This account will usually include unpaid amounts between affiliated companies. This could arise from sales, loan advances, allocation of income and expenses, or payment of each other's expenses.

Inventories. The bulk of inventory is made up of caskets and urns. Other inventory items will consist of burial clothing, embalming supplies, cremation cartons, registration books, acknowledgement cards, memory folders. Caskets maintained in inventory are usually limited to one floor sample of each style and maybe a small (five to ten) inventory of the most commonly purchased caskets. Unique or very expensive casket models can be selected from a catalogue. Since manufacturers deliver caskets within a day, there is no need to maintain a large number because of availability and limited storage space.

Selections of burial clothing includes negligees, underwear, dresses, men's shirts and suits. The clothing items are specifically manufactured for ease of fitting to a corpse. They are not adaptable to every day wear. Even though the embalming supplies are inventoriable items, all the mortuaries examined expensed them when purchased since they are highly flammable and city fire departments did not allow them to store large quantities on the premises.

The larger mortuaries have in-house printing facilities so they tend to buy printing materials in bulk so they can internally personalize the registration books, acknowledgment cards and memory folders ordered by clients. These items are recorded as inventory when purchased and amortized on a monthly basis over a period of not more than one year. Smaller firms order from suppliers and printers as required and expense these costs as purchased.

Fixed Assets. This may include mortuary land and buildings, limousines, hearses, pickup vehicles, furniture, office equipment, leasehold improvements.

Other Assets. This may consist of various intangible assets such as goodwill, covenant not to compete (if purchase of other mortuaries has occurred), and various pre-payments.

Liabilities

Trade Accounts Payable. These are bills outstanding from purchase of goods and services.

Cash Advance Liability. This account is made up of cash advance items purchased by clients and charged to them by the mortuary in the funeral sales contract. Refer to Accounts Receivable above for further discussion.

Income

Account titles will describe the income source. These may range from only a few general accounts to a separate account for each item on the contract. Typical account descriptions would be as follows:

Funeral Services. This account consists of a standard charge for the providing of mortuary professional services (which includes the funeral director counseling) and facilities.

Caskets. This account represents the sale of caskets.

Clothing. This account represents the sale of burial clothes.

Miscellaneous Accounts. This account consists of charges for chapel services, limousines, escorts, embalming, funeral programs, memorial folders, viewing/visitation.

Flowers. This account applies to those mortuaries who own and operate flower shops on their premises or as part of their business. For those mortuaries who purchase flowers from outside vendors, the flower account is usually a cash advance item.

Cash Advance Income (a.k.a. "Accommodation Income" or "Funeral Outlay Income"). This account is set up when mortuaries recognize cash advance items as sales instead of liabilities. It is made up of cash advance items paid and incurred by the mortuary on behalf of their clients. The cash advance items are charged to the clients and a cash advance income account is created. The payment of the actual bills may be lumped into a cash advance expense account but will more likely be allocated directly to the specific account titles. The net effect of the cash advance income and expense accounts should theoretically be zero, because there is no mark-up applied. Examples of cash advance items are death certificates, obituaries, limousine service, escort services, vocalist, minister.

Insurance Commission. This is earned by the mortuary as a licensed insurance agent on the sales of life insurance policies to clients purchasing coverage for future funeral costs. This may come in various forms such as sales commission, marketing allowance, activity bonus and profit sharing commission.

Expenses

Cost of Sales. This is comprised of various types of accounts depending on the inventory system the taxpayer uses. They could be under the periodic system or the perpetual system. Under the periodic system all purchases, whether of goods or services, will be charged to a Purchases account (expense). While, the perpetual method of inventory will charge purchases of all inventoriable items to the specific inventory account (asset). A sale will trigger a reduction to the Inventory account and a charge to Cost of Sales (expense). Both systems were encountered.

Cash Advance Expense (a.k.a. "Accommodation Expense" or "Funeral Outlay Expense"). This account is made up of cash advance items paid or incurred by taxpayer for their client's convenience. The same amount would have been previously charged to clients and recognized as cash advance income. Refer to Accounts Receivable and Cash Advance Income account explanation above for further discussion of items included.

Advertising/Promotion. The advertising amount incurred depends largely on the size of the mortuary. The larger companies advertise extensively through television, radio, newspapers and publications, whereas the smaller ones mostly utilized the local and community newspapers geared towards the community they serve. Almost all of them advertised through telephone directory yellow pages and church publications.

RECORDS TO EXAMINE

Shown below is a summary of records found to exist in the industry.

Sales Funeral Book

This book is an independently kept recording of each funeral which the mortuary provided. It was found to be kept by small to medium mortuaries. The larger firms, which were on computer, did not maintain this book since the records were readily accessible by computer.

The book was generally a prebound volume kept on a yearly basis. The book is a series of pre-printed forms which is completed for each funeral and contains the personal background of the decreased as well as a complete summary of the funeral billing including any cash advance items paid for by the customer. It was generally handwritten and chronologically numbered for all funerals occurring in the year. Funeral homes were found to use either the date of death or date of disposition as the recording date for the sale. The funeral book was traceable directly to the sales journal, accounts receivable and liability accounts depending on the method used for recording cash advance payments. See cash advance explanation under Accounts Receivable.

Funeral Sales Contract

This is the mortuary's sales invoice and it is generally the only document a client signs. The contract itemizes each item purchased such as services, merchandise, and cash advance items. A sample of a joint mortuary/cemetery contract is included at Exhibit 7-1

Customer Ledger

Smaller firms who quite often are on the manual bookkeeping system, kept one ledger for each individual client and updated it manually. The larger firms have computerized printouts of each individual client's payment history and balances. However, only the most current year is kept since they are able to access customer accounts on the computer at any time.

Deceased Folder

This folder contains everything pertaining to a particular client. Included are the funeral sales contract, copy of death certificate, embalming authorization, assignment of insurance proceeds by beneficiaries to the funeral home, correspondence and collection history. Actual vendor bills paid would not be included in this folder.

Vendor's Invoices

Most expenses claimed will have invoices to enable the examiner to determine its allowability. Some expenses, especially those paid to individual providers such as ministers, soloist, outside embalmers, churches, may only have canceled checks for substantiation.

POTENTIAL AUDIT ISSUES

Examinations of the mortuary cases resulted in adjustments to items which can be classified as common to all tax cases (T&E, use of auto, accounting errors, etc.). The issues below were particular to the industry. However, normal audit judgment and procedures should be applied to any accounts which the agent identifies as unusual or excessive. Each of the issues is discussed in the following context when pertinent.

1) General discussion of issue.
2) Records to request or review.
3) Suggested audit steps.

PROFIT AND LOSS STATEMENT

Income-General Discussion

A mortuary's gross receipts may come from the following sources:

a) Professional services and sale of merchandise as the result of the funeral services.
b) Commission payments received on sale of funeral insurance policies.
c) Income from the administration of funeral trusts or revocation fees charged for cancelled trusts.
d) Rental of limousines to other funeral homes or for other uses.
e) Cash advance items.

Every examination should entail a review of income. Internal control should be tested to assess its reliability. Depending on the strength or weakness of taxpayer's internal control, audit procedures employed for income verification will range from testing of sales transactions for a month to a detailed bank deposit analysis. The agent's reliance on the certified audit may minimize the audit procedures the agent chooses to perform but certainly does not warrant omitting his or her own testing of income.

Unreported Income - Discussion of Issue

Since most of the smaller companies are closely held and managed by shareholders/officers, it was found that the financial activities were handled by the same people who were also in charge of record keeping. Unreported income could arise from instances such as omitting an entire funeral service, cash sales, income from rental of limousines to others, omitting insurance commissions or misappropriation of funeral trust funds (if taxpayer is trustee).

Records to Request or Review

1) Sales funeral book

2) Sales journal
3) Funeral sales contracts
4) Vendor's invoices or check stubs
5) Bank statements for business accounts and trust plan accounts
6) Independent reports (Vital Statistics)

Suggested Audit Steps

1) Test a sample of individual funeral sales contracts to the sales funeral book entries and to the sales journal. Question the taxpayer about any discrepancies noted.

2) On smaller mortuaries, a bank deposit analysis should be performed and any material differences explained and reconciled by the taxpayer.

3) Select a sample of cash advance vendor invoices (or canceled checks or check stubs) and trace deceased names and amounts back to the sales funeral book and sales journal to determine if cash advance income and all sales have been properly recorded.

4) If a taxpayer is the trustee of a funeral trust plan and has access to the trust bank account, a test of withdrawals from the trust account should be made and matched to the sales funeral book and sales journal to determine that all sales have been properly recorded. Any withdrawals for items other than funerals should be questioned. These may be administrative fees or unauthorized use of funds. In either case these withdrawals should be reported as income. If these trust funds are commingled with the company's regular bank accounts, this may not qualify as a trust and amounts received from clients are taxable as advance payments for services because there is no restrictive use of funds.

5) If fraud is suspected, the agent may trace death certificates filed with the Los Angeles County Recorder's Office. The agent may also acquire reports prepared by companies such as "Vital Statistics" which summarizes the number of funeral services handled by individual mortuaries. The taxpayer should be asked to explain any differences.

Sales Cutoff Test - Discussion of Issue

Improper sales cutoff will result in the taxpayer postponing income recognition to the following taxable year or even omitting its recognition entirely. Sales are included in income when the service or merchandise is provided regardless of when the invoice is sent or recorded in the books. Cutoff criteria may differ for financial and tax reporting purposes and therefore, even if there is a certified audit the agent still should test for cutoff.

Records to Request or Review

1) Subsequent year's sales journal

2) Funeral sales contracts

3) Deceased file folder

Suggested Audit Steps

Choose a sample of funeral sales contracts (or deceased file folder if contracts are not filed separately) processed after the tax year-end and check to see if income was recorded in the proper year. Start with period covering at least one week after the year end and expand depending on the results. The proper time for reporting the income would be at the completion of the funeral services.

Flower Trust Advance Payments - Discussion of Issue

Mortuaries who also own and operate flower shops (usually on their premises) have the advantage of being able to offer their clients long term flower purchase arrangements for future placements on cemetery plots. The client can select the type of flowers, the frequency of placement, and the desired dates or occasions. An advance payment is required from the client at the time of sale and is deposited into the taxpayer's general account upon receipt. Since the taxpayer is not restricted in use of the funds, income should be recognized at the time the payments are received instead of recognizing it as a liability. Several court cases have concurred with this treatment.

Records to Request and Suggested Audit Steps

Ask the taxpayer if this type of arrangement exists and if so, how is it treated on the taxpayer's books.

Funeral Insurance Commission - Discussion of Issue

Records to Request and Suggested Audit Steps

1) Determine if the taxpayer offers funeral insurance by itself or through independent companies and obtain the following:

   a) Obtain brochures explaining the insurance plan to clients.
   b) Obtain a sample contract signed by clients.
   c) Obtain copies of agreements between the mortuary and independent insurance company which sets forth the amount of compensation to the mortuary and when and how payment is to be received.
   d) If the mortuary is offering insurance through an independent insurance company, determine if the payments from clients are made directly to the independent insurance company or through the mortuary. If made through the mortuary, does the mortuary regain any portion?
   e) Have the company provide the monthly statements received from the

independent insurance company. Determine if the mortuary received the full amount or if the independent company held any portion in reserve which is to be paid at a later date.

Records to Request or Review

1) Advertising contracts.

2) Contracts between entities regarding sharing of advertising cost.

3) Sample of advertising bills.

4) Sample of actual advertisements on radio, television, billboards, newspapers, yellow page directory, and brochures.

Suggested Audit Steps

1) Sample advertising bills (or advertising contract if no bills are presented for payment) for at least a month to determine if claimed amount is proper.

2) Review allocations made pertaining to the different media bills.

3) Review a sample of the actual radio and television tapes, newspaper advertisement, directory advertising in the yellow pages, printed brochures, photographs of billboards, etc. to determine the validity of taxpayer's allocation.

4) If the taxpayer does not appear to have a reasonable allocation method, consider reallocation of the bills based on the determination of who the advertising actually benefited and/or consider the use of sales ratios to reallocate the expenses.

EDP, Accounting, Personnel, and Officers Salaries - General Discussion

Related entities, especially when they share locations, more than likely will also share personnel and facilities. If no allocation is made for these items, determine why not. If an allocation was made, the taxpayer should provide a basis for the rate used. This should be reviewed to determine that the allocations made are reasonable. If no tangible basis was used, make the adjustment based on a reasonable allocation such as the ratio of total sales to each entity's sales.

Rent, General Discussion

Occasionally, an arrangement may be made where one entity leases real and/or personal properties to a related entity. This may be structured in such a way that the exempt or loss entity is the lessor, so that the rental income (which could be inflated) escapes taxation while the taxable entity (the lessee) gets the benefit of the deduction. Consider the assistance of an engineer in appraising the various properties' fair rental value.

Records to Request or Review and Suggested Audit Steps

1) Inspect lease agreements between the parties and determine properties being leased and the basis of rent being charged.

2) If rent is being allocated between an exempt and taxable entity, determine exact properties being allocated, basis and reasonableness of allocation.

Utilities - General Discussion

This includes water, power and gas which is allocated between the parent cemetery company and the subsidiary mortuary. Utility bills should be reviewed and locations and areas serviced by the meters identified, to determine that the allocation is proper. Based on the facts of the case, determine which company would incur the type of utility being allocated. For instance, water usage will be substantial for the cemetery, because of the lawns being watered. Gas and electricity might be substantial for the mortuary because of the maintenance of the mortuary buildings. If the cemetery operates a crematorium, gas usage may be substantial.

Below Market Interest Rate - General Discussion

Affiliated or related entities, which sell and purchase between each other, pay each other's expenses, or allocate expenses to each other will, as a result, have an intercompany receivable/payable account to facilitate accounting for these transactions. IRC Section 482 provides for interest to be charged on these intercompany balances. A situation was observed wherein a taxable and profitable entity charged a below market interest rate (below the AFTR rate for the year) on the outstanding intercompany receivable from the exempt entity (mostly arising from its regular sales activity) and as a result the interest income reported by the taxable entity is lower than what was actually earned (based on the AFTR rate). The interest rate charged between the taxable and the exempt cemetery was half the interest rate charged to other taxable affiliates. Even though there was a contract for the below market rate, it was disregarded and an adjustment was proposed applying the same rate as that charged to the other taxable entities.

Treas. Regs. 1.482-2 sets allocation rules for specific items and one of them is for imputed interest on intercompany loans, advances, and debts arising in the ordinary course of business from intercompany sales, leases or rendition of services. The principles of IRC Section 483 (imputed interest on sales) is followed in imputing interest rates where interest rates charged were too little or too much.

Individuals Living at Mortuary - Discussion of Issue

The nature of the funeral business is such that it requires someone to be in attendance 24 hours a day to answer telephone calls, to meet with the decedent's relatives, to make financial arrangements, and to arrange to pick up the deceased. The funeral homes are open for visitation, viewing, and counseling during normal working hours only. Most hospitals and retirement homes require relatives to have the deceased moved into a funeral home within a day of death due to limited or lack of refrigeration space. A mortuary has to be available at all times to handle these pick-ups.

Usually the live-in person takes all calls but other employees handle pick-ups. It takes at least two people to handle a body pick-up. At times when the live-in person is unavailable, a "sitter" may be made available to answer calls. Lodging on the premises provided to employees was observed to be prevalent among the smaller companies. The larger mortuaries avoided this live-in arrangement because they are able to afford a night shift and body pick-ups were handled by outside companies. An issue could arise where family members were provided living arrangements either in the same building or close to the funeral home.

Records to Review or Request

Employment contract.

Suggested Audit Steps

1) During the initial interview, inquire about living arrangements provided for by the mortuary and where living quarters are located.

2) Conduct a tour of the living quarters and note expensive and extraordinary appliances, furniture provided, especially when family members or relatives are occupying premises. Trace purchases to asset and depreciation schedule.

3) For occupants who are family members, determine whether they are employed by the mortuary and are actually performing the jobs they were hired to do.

4) Inspect the employment contract signed by the employee living on the premises to see if it was a condition of employment.

Bad Debt-General Discussion

A bad debt issue arose when a related exempt or loss cemetery and taxable mortuary were using one sales contract to record at-need cemetery plot sales and mortuary sales. The recording of the sale by the company reflected the proper amount of sale to each of the entities and set up the proper intercompany receivables and payables.

However, when the account was determined to be uncollectible, the entire bad debt was charged off against the mortuary's income only.

Records to Request or Review

1) List of bad debt write-offs.

2) Sample of deceased file folders (should include all correspondence with clients, attorneys and collection agency.)

Suggested Audit Steps

1) Determine the company policy for bad debt writeoffs. If company has a loose policy on bad debt writeoffs, consider a larger sample size.

2) Determine how the amount written off is reflected on the books. Was it applied proportionately to the appropriate companies (cemetery and mortuary) or was it applied only to the taxable entity?

3) Determine whether or not there were any recoveries received during the year and how were they accounted for.

BALANCE SHEET

Accounts Receivables - General Discussion

Often, mortuaries are paid from the proceeds of a decedent's life insurance policy (not a funeral life insurance policy). The beneficiary has to sign the assignment form which is sent by the mortuary together with the death certificate to the insurance company. If proceeds are in excess of the funeral charges, a refund is sent to the beneficiary. A test of refunds should be made to determine how the excess amount is booked when received and how it is booked when refunded. Most of the time the entire insurance proceeds were booked as receivable and the refund was charged to the receivable account. Be aware that the refunds may be expensed and claimed as a deduction.

Cash Advance Liability - General Discussion

This account will be on the books if the taxpayer is recording the payment of cash advance items for clients as accounts receivable instead of showing them as income and expenses. The net balance of the cash advance liability accounts should theoretically be small since it only represents the outstanding amounts due to cash advance vendors. Examples of cash advance items are death certificates, obituaries, limousine service, escort services, vocalist, and honoraria to ministers.

Records to Request or Review

1) Vendor's invoices for cash advance items.

2) Canceled checks or check stubs when no vendor billing is submitted for payment (such as honorariums, soloist, pallbearers).

Suggested Audit Steps

1) Determine what cash advance items are included in the cash advance accounts receivable and liability accounts. It was noted during the examination that sometimes items included in the cash advance liability account were not the same amount booked as accounts receivable because taxpayer would incur more for the cash advance item than was charged to the client (i.e. taxpayer would charge the client for a one day obituary but let the obituary appear in the newspaper for several days). This resulted in the liability account having a debit balance which was then closed against the sales account. Any appreciable debit balance which is closed out against the sales account should be explained by the taxpayer.

2) On a sample basis, trace some cash advance vendor invoices paid to the funeral sales contract and to the cash advance liability account to determine that they are properly recorded as liability items and not expensed. Each of the cash advance vendor invoices identified the funeral by the name of the deceased. The income items were also booked by the name of the deceased.

Goodwill vs. Covenant Not to Compete - General Discussion

As stated previously in this guide, this industry appears to be in a period of consolidation, and as such there were several instances of mortuaries buying other mortuaries. In each of the cases the value assigned to the goodwill vs. the value assigned to the covenant not to compete was an issue.

Prior to 1987 the allocation of the purchase price of a business among the assets being acquired put the purchaser and seller in opposing positions. The purchaser basically wanted the highest possible FMV to be assigned to inventory, depreciable and amortizable assets in order to get the largest possible write off of the cost. On the other hand the seller wanted the amount in excess of the FMV of the asset to be assigned to goodwill, since it is a capital asset to which a lower capital gains tax rate was applied.

In the past when the parties were in this adversary position, the courts tended to respect the parties allocation of the purchase price. When the Tax Reform Act of 1986 largely eliminated the preferential tax treatment for capital gains, a good deal of the conflict in bargaining positions was also eliminated. Subsequent to the 1986 Act, the buyer will still attempt to allocate the bulk of the purchase price to inventory, depreciable and amortizable assets while the seller has little reason to dispute the allocation.

Because of this reduced conflict between purchaser and seller in determining reasonable values of the various assets, Congress felt there existed potential for unreasonable allocations and therefore IRC section 1060 (the residual method) was enacted. Under this method of allocation the purchase price is distributed to assets in the following order:

1) Class I - Cash, demand deposits, and similar accounts in banks.

2) Class II - Certificates of deposit, United States Government securities, readily marketable stock or securities, foreign currency and other similar items in proportion to their respective fair market values on the purchase date.

3) Class III - All other transferred assets, tangible and intangible in proportion to their fair market values on the purchase date.

   tangibles: furniture, fixtures, inventory, accounts receivables, buildings, land, equipment.

   intangibles: covenants not to compete, customer and subscription lists, other assets not on sellers balance sheet.

4) Class IV - Goodwill and going concern value.

Both the buyer and seller are to use the residual method of allocation and both are required to notify the Internal Revenue Service of the allocation. This notification is made on Form 8594 (Asset Acquisition statement under IRC section 1060) and attached to both parties' tax return for the year in which the sale occurred. In addition to the covenant not to compete agreement, the acquisition may also stipulate employment or consulting agreements. This allows the purchaser to write-off part of the purchase price as ordinary business expense in the guise of salary or consulting expenses.

As in the past, the Internal Revenue Service can attack the allocation of the purchase price if the residual amount allocated to goodwill or going concern value is unreasonably low and the value assigned to the covenant not to compete agreement, employment or consulting contract appear unreasonably high. The taxpayer should therefore be able to provide the following:

1) Value and life of the covenant.

2) That the value allocated to the covenant was the subject of serious negotiations and it was enforceable.

3) The covenant has economic reality in that the seller intended or could enter into competition with the buyer.

4) The amount paid for consulting or employment contracts is reasonable and is for services being performed.

If the business is a corporation and the assets are sold, the corporation may then be liquidated. In some instances the seller may wish to retain the nonactive corporation as an investment vehicle if the shareholder has a very low basis in the stock for which a large tax to the shareholder would result from liquidation. The shareholder may invest the proceeds form the asset sale and receive dividends or interest income. This type of corporation may be classified and taxed as a Personal Holding Company (PHC). Under IRC Section 541 PHC's are subject to an additional tax of 28 percent on undistributed PHC income.

If the situation arises where affiliated entities are involved in buying and selling a mortuary from one another, it is possible that no value should be assigned to the covenant not to compete agreement.

Prior to 1988, a significant factor to remember in connection with the purchase and sale of a business was the depreciation recapture rules. The elimination of the preferential tax treatment of capital gains made the depreciation recapture less significant. However, a corporation with a capital loss would still be concerned about the classification of the gain reported since the loss can only be offset against capital gains and any loss carry-forward would be lost after five years.

In two instances where the installment sales of a mortuary business were reviewed it was found that the taxpayers failed to properly include the depreciation recapture income as required by Section 453(I) of the IRC and in both cases, a substantial adjustment was made. Due to the complexity of the installment sale method, should the agent encounter the sale of a mortuary or cemetery, it is recommended that Section 453 of the IRC and Publication 537 be reviewed.

Records to Request or Review

1) The complete sales contract and all amendments.

2) The covenant not to compete agreement.

3) Copies of the sellers tax return for at least the past five years to determine how profitable (or unprofitable) the business was.

4) Seller's depreciation schedule to determine the original cost and book value of all the assets sold.

<u>Suggested Audit Steps</u>

1) Determine from the sales contract the values assigned to the tangible and intangible assets by both the seller and buyer.

2) Determine the sellers reason for selling the mortuary business.

3) Determine if the seller has any intention of going into the mortuary business again, and if not, why not (the age, past and present health of the seller may be factors to consider)?

4) What was the seller's reputation in the community (good or bad)?

5) What was the goodwill when the seller acquired the business from the previous owner, if applicable?

6) What was the covenant not to compete value when the seller acquired the business from the previous owner, if applicable?

7) What was the covenant not to compete value when the seller acquired the business from the previous owner, if applicable?

8) What was the status of the seller's funeral director's license at the time of purchase (is it in good standing or has it ever been revoked)? This information can be obtained from the State Funeral Board.

9) Determine how long the seller has been in the mortuary business.

10) Determine what the seller is presently doing.

11) What was the sellers reasoning or part, in valuing the covenant not to compete? Was the seller's agreement to the buyer's allocation a condition of the sale?

12) Refer to the seller's depreciation schedule to determine the book value of the tangible assets and their original cost. Compare these amounts to the values assigned by the sale contract.

    a) If the asset was an auto, the agent can look up the value in the Kelly Blue Book. If the auto was a limousine, then the agent can refer to monthly mortuary magazines such as "Mortuary Management" where selling prices of various old and new limousines can be found.

b) If the agent does not agree with the allocation of the purchase price among the various assets, engineering assistance should be considered.

Forms 1099

During the course of its operation, various payments are made by the mortuary to individual payees for services rendered such as escort services, soloists, pallbearers, gardeners. Ministers (but not priests) are taxable on payments for their services unless the payment is remitted by them to the church.

It should be determined whether payments to each individual exceeded $600 for the entire year and if Forms 1099 were issued as required. If none were issued, penalties may have to be assessed against the funeral home. Also, consider expanding the audit to include payees.

One medium-sized mortuary examination was expanded to include the escort service and gardener because Forms 1099 were not issued to such individuals. All of them omitted the income from their individual returns. (See the synopsis of an escort service examination below.)

Escort Companies

Escort companies are in the business of escorting the funeral procession on motorcycles. Each mortuary examined calls upon certain escort companies on a regular basis. If the escort company receives more appointments for funerals than they can handle, then they will contract out with certain individuals who frequently have other full-time jobs.

The number of cars in the funeral procession determines the number of motorcycle escorts needed. During 1988 and 1989, the fee charged by the escort companies to mortuaries in the Los Angeles area was approximately $75 per motorcycle escort. This $75 fee is the fee charged by the mortuary to the customer through the cash advance account. The mortuaries audited did not make a profit on this service provided to its customers. The escort company paid a fee of $40 to those subcontractors used on an as-needed basis.

Generally escort companies maintain a detailed daily diary of all escort runs made by the escort company and subcontractors. Escort companies generally billed the individual mortuaries on a monthly basis for all runs conducted for the mortuaries. The runs were identified by the names of the various deceased individuals.

The escort company should receive Forms 1099 (if not incorporated) from all mortuaries to which it rendered services. The escort company should also be issuing Forms 1099 to the various individual subcontractors.

In one instance where a mortuary failed to issue a 1099 to an escort company, the audit was expanded to the escort company. It was found that all income was not reported by the escort company. Income on the escort company was then reconstructed by analyzing the following:

1) Determining the number of escorts provided during the year from the company daily diary of call sheets, and multiplying this by the average fee of \$75 per call (not including subcontractor runs)

PLUS

2) Totaling the gross amount paid to subcontractors as follows:

$$\frac{\text{Total subcontractors payments x \$75}}{\text{\$40}} = \begin{array}{l}\text{Amount billed to}\\ \text{mortuary re: subcontractors}\end{array}$$

3) The total of these two amounts was compared to the amounts reported as income per return and adjusted accordingly.

Section 7

CEMETERIES

GENERAL OVERVIEW

The cemetery business may include the burial of human remains in the following manners depending on the facilities of each particular cemetery:

1) Burial of caskets and urns containing remains in individually set ground burial vaults or preconstructed crypts.

2) Burial of caskets and urns containing the intact or cremated remains in mausoleums or columbariums.

3) Scattering of cremated remains in designated areas of the cemeteries.

A cemetery is generally a separate independent organization operating unrelated to any particular mortuary. However, some large cemeteries may also operate a mortuary on the same cemetery grounds. In these cases the cemetery was usually found to be a separate entity. This was largely due to the fact that the cemetery is allowed to be a tax-exempt organization while a mortuary business is not.

The charges which a cemetery will make for its services will generally include the ground interment spaces, lawn crypts, mausoleum space or niche, a vault liner or urn, a fee for the opening and closing of the grave, a marker or headstone, a fee for setting the marker or headstone, a flower container, a fee for setting the flower container, flowers, cremation, recording fees. A cemetery company can operate a crematory, however, there is a separate license to do so. A crematory may also be an independently operated business. A mortuary cannot operate a crematory under its mortuary license. A mortuary may make the charge for cremation to its client through its cash advance, and have the cremation done by an independent crematory or cemetery.

One of the taxable cemeteries reviewed also operated a flower shop located on the cemetery property. Several of the mortuaries reviewed owned and operated flower shops as part of the mortuary business. If the cemetery is an endowment care cemetery (discussed below) there will also be a fee for the endowment care which will be transferred to an endowment care trust. California state law decrees that the last dollars collected on a cemetery contract are the endowment care dollars. The death certificate and the burial permit were usually obtained by the mortuary. The burial permit is given to the cemetery at the time of burial. It is forwarded to the registrars office of the health department in the county of final disposition. All other copies can be destroyed one year after burial.

The selling of cemetery property is presently made on an at-need basis (immediate use of the property) or pre-need basis (where the planned use is for some future date). The sale of property on a pre-need basis has become an increasingly large part of the cemetery business. A typical pre-need sale contract consists of a down payment with installment payments made over a five-year period plus interest. It appears that most cemeteries require full payment for a grave site before it is allowed to be used, however, one company did allow occupancy prior to payment.

Once a grave space is paid for, a conditional deed is issued to the owner and a mass recording is done through the county recorders office. The deed restricts the use of the property to the disposal of human remains within the laws and regulations of the cemetery. This recording relieves the cemetery of property taxes on the sold and paid-for plots.

The sale of at-need cemetery property is done by the in-house staff (employees) of the cemetery and memorial counselors of related mortuaries, while the sale of pre-need property was found to have a staff of door-to-door salesmen. The salesmen for the cemeteries were treated as commissioned salesmen or as employees depending on the amount of control that the company displayed. One cemetery had a sales force which operated out of their homes on a part time basis with no set hours, specified territory or training etc., while another had full-time supervised salesmen. The sales staff of the cemetery may also be supported by a telephone staff which makes calls ahead of the salesman's calls so as to pinpoint more prospective customers.

Pre-need sales can be sales of property in previously completed lawns of the cemetery or in lawns to be constructed in the cemetery in the future. Many pre-need sales take place at the time of a related at-need sale or soon after since the cemetery industry recognizes that the death of a spouse may give rise to the potential pre-need sale of a plot to the remaining spouse.

Cemeteries are generally segregated into different lawns. Each lawn is a separate section of the cemetery with a designated name (Garden of Angels etc.) and may have a particular theme, religious or ethnic background attached to it. Generally the grave sites in each particular lawn of the cemetery will have their own numbering system.

Other than the grave vaults or crypts, each lawn of a cemetery has the following improvements made to the land.

1) Roads, curbing and walkways

2) Trees and shrubs

3) Automatic sprinkling system

4) Lighting

5) Drainage system

6) Sod

7) Placement of the markers to determine occupied and available graves

8) Features

The accomplishment of the above may involve considerable time in engineering, surveying and grading. The cemetery may also have administrative buildings along with chapels, monuments and other features of public interests. The timing of the construction and presale of grave space may differ from cemetery to cemetery depending on the financial strengths of each.

One company with the financial ability constructed the entire lawns of the cemetery prior to any sale of grave sites (at-need, pre-need) while another pre-sold the graves under a five-year installment contract, and only started construction after a substantial amount of money was collected. This reduced the company's need to borrow funds and incur interest costs. Any deaths which occurred prior to the completion of the lawn were placed in a previously completed section of the cemetery as had been provided for in the original contract.

In the past the installation of a grave site meant the removal of the existing sod, digging of the grave, installation of the concrete vault liner, insertion of the casket, replacing of the soil and sod and the installation of the grave marker or headstone. Most cemeteries require the use of the concrete vault liner so that the eventual decay of the casket itself will not cause the earth to settle and give the cemetery an unsightly appearance.

Presently, some of the larger cemeteries have begun to pre-construct the grave site. These are called lawn crypts. The lawn crypts are pre-constructed concrete vault liners constructed to resemble a bee hive honeycomb. The crypts are connected but have individual tops. They remove the need for any space in between graves. They can be constructed four graves deep.

The construction of the crypts entails the removal of all of the soil to the depth required (depending on how many graves deep the establishment wishes to have) the installation of a water drainage system (gravel and drainage pipes), the installation of forms and the pouring of the crypt structure (steel reinforced concrete), the replacement of the soil and sod. A grave marking system is set in place so that when a particular crypt is to be used the sod and soil can be removed quickly, the casket inserted and the soil and sod replaced. The actual crypts are approximately 18 inches below the surface. The trees and features are pre-planned into the overall honeycomb. The construction of such a lawn can entail three thousand graves at a time.

Taxable vs. Non Taxable Cemeteries

Cemeteries can be operated as taxable or non-taxable organizations. IRC Section 501(a) provides that any organization described in subsection © or (d) or Section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under Section 502 or 503. Section 501(c)(13) qualifies the following for tax exempt treatment:

> Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for the purpose of the disposal of bodies by burial or cremation which is not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

There are reported to be between 75,000 and 100,000 cemeteries in the United States. Most of these are tax exempt organizations. In the Los Angeles area there are approximately 63 cemeteries and crematories. In March of 1989, 83 percent of the burials were handled by 22 of these cemeteries. An analysis of burial data compiled revealed that, of those cemeteries and crematories which did 83 percent of the burials in March of 1989, 72.2 percent took place in tax exempt cemeteries.

Over the years, there have been a considerable number of court decisions pertaining to the tax exempt status of cemetery companies. These cases focus on the loss of tax exempt status due to:

1) The inurement of benefits to shareholders or individuals.

2) The operation of businesses by the cemetery which are unrelated to the disposal of bodies by burial or cremation.

The synopsis of cases pertaining to the tax exempt status of cemeteries may be reviewed to get a feel for the current court interpretation of what constitutes enough inurement of benefit to shareholders to cause a loss of exempt status. Since the examination of tax exempt cemeteries will be performed by the Exempt Organization Division of the IRS, the qualifications or disqualifications of an entity will not be discussed. If, during the course of an examination of a taxable entity, it is determined that a company is owned by an exempt organization and the agent has doubts as to the validity of its exempt status, a referral to or discussion with Exempt Organization should be considered with concurrence of the agent's group manager.

Endowment vs. Non Endowment Care Cemeteries

Cemeteries in California can be endowment care or non-endowment care cemeteries. Endowment care cemeteries are those that charge a fee which is placed in a trust fund to provide for the perpetual care and maintenance of the cemetery. The cemetery must state on the cemetery entrance that it is or is not an endowment care cemetery.

It appears that almost every cemetery has established and operates an endowment care fund (ECF) because it is a good advertising tool. It convinces buyers that their graves will be maintained in good condition in perpetuity.

The State requires that the funds be kept separate and apart from all other cemetery funds and that separate books and records be maintained for the ECF. There is no federal requirement on how the funds should be established. To comply with the state requirement, the ECF may be established by either creating a trust entity apart from the cemetery entity or simply by opening a bank account to separate the ECF from all other assets of the cemetery. The funds may be held in the name of the cemetery authority, its directors, or its appointed trustees.

To establish the fund, the State requires an initial deposit of $35,000 if established on or after 1/1/77. Henceforth, additional amounts deposited shall be a minimum of:

1) $1.75 a square foot for each grave sold.

2) $25.00 for each niche sold.

3) $75.00 for each crypt sold and $40.00 for each additional crypt when a companion crypt is purchased.

The State requires that every cemetery authority in charge of endowment care funds shall file an ECF report (Form 27M-7) showing the total number of graves, niches, crypts sold, the computation of the ECF funds required to be deposited into the fund, and how the funds are invested. The report also requires disclosure of any transactions entered into between the cemetery or any officer, employees or stockholders thereof and the trustees of the endowment fund pertaining to the endowment care funds. The report is a public record (Section 9650.3 of the Cemetery Act, Business and Professions Code, Chapter 19) and is to be open for public inspection at the offices of the cemetery during normal business hours. The fund contribution should not be less than the minimum state requirement.

Normal practice appears to be to deposit amounts in excess of the state requirements because the state requirements are insufficient to build the fund to the point where the income can cover all of the normal maintenance expenses. This is done by charging the buyer a fixed amount or a percentage of the plot sales price. The portion of the sales contract pertaining to any of the endowment fund amounts is recorded on the cemetery books as a liability to the trust fund. The eventual collection of the amount on final payment by the customer and transfer of the money to the trust relieves this liability.

The funds received and set aside in a separate trust for the endowment care of a cemetery under provisions of state law or under the corporation's own by-laws or contracts are not to be included in the gross income of the cemetery (RR 58-190).

There are two types of endowment care funds:

1) Exempt - if established by a nonprofit cemetery.

2) Non-Exempt - if established by a for-profit cemetery.

   The income earned by the endowment care trust created is taxable if it is set up by a taxable cemetery and not taxable if set up by a non-taxable cemetery (RR 58-190 and RR 64-217). This prevents the use of tax exempt income to support a privately owned taxable cemetery.

   If the cemetery authority did not create a separate trust entity for the ECF, all income earned by the ECF such as interest, dividends, and capital gains will be reported on the cemetery authority's tax return.

   If the cemetery authority created a separate and distinct ECF trust entity, the trust will be required to file a United States Fiduciary Income Tax Return Form 1041. All ordinary income and capital gains earned by the trust will be reported on its own return. A special deduction under IRC 642(I) is allowed to ECF trusts making distributions to taxable cemetery corporations but is limited as outlined below. A taxable cemetery corporation is defined as a corporation (within the meaning of IRC 7701(a)(3)) engaged in the business of owning and operating a cemetery which is either (1) not exempt from tax or (2) is subject to tax under Section 511 with respect to its cemetery activities.

   a) The deduction may not exceed $5 multiplied by the aggregate number of grave sites <u>sold</u> by the cemetery corporation before the beginning of the taxable year of the trust. The grave sites must be those which the cemetery has an obligation to care for. The obligation may be established by the trust instrument, local law or past practice. A grave site is considered sold when the purchaser acquires interment rights enforceable under local law.

   b) The amount of the deduction otherwise allowable for the care fund distribution in any taxable year shall not exceed the portion of the distributions expended by the distributee cemetery corporation for the care and maintenance of grave sites before the end of the fund's taxable year following the taxable year in which it makes the distributions.

A six month extension of time to file the trust return may be obtained by request under IRC 6081. The failure of the cemetery to expend the care funds distributions within a reasonable time before the due date for filing the return will be considered reasonable grounds for granting a six month extension under IRC 6081.

c) Any direct payments made by the ECF directly for the care and maintenance of the grave sites (not through cemetery) will be treated as an additional ECF distribution expended on the day of distribution by the ECF and will be allowed as a deduction in the taxable year of expenditure.

The cemetery will provide to the ECF a certified statement specifying the number of grave sites sold and the amount spent by the cemetery for their care and maintenance. The statement must indicate how the cemetery determined the portion of the total expenditures allocable to the care and maintenance of the sold grave sites. The statement must be certified by an officer or employee of the cemetery who has the responsibility to make or account for the expenditures. A copy of the statement must be kept by the ECF and must be made available for inspection if requested by the Secretary or its delegate.

STRUCTURING OF COMPANIES

Cemeteries range from small, individually operated businesses offering only at-need grave sites to large multi-site operations with crematories, mausoleums and columbariums set in park like settings. All of the cemeteries reviewed were corporations. The structuring of the companies in the industry appears to include C corporations, S corporations and tax exempt corporations. The larger organizations appear to be tax exempt cemeteries run as associations which have wholly-owned taxable mortuaries which may, in turn,have wholly-owned subsidiaries doing business in other related mortuary fields such as insurance or land acquisition and development. There may also be additional related corporations which purchase, develop and sell grave sites to the exempt or taxable cemeteries.

METHODS OF ACCOUNTING

Prior to 1/1/87 the reporting of sales of cemetery property was done as follows:

1) At need sales - Accrual Method.

2) Pre-need sales - Installment Method.

At-need Sales Accrual Method

Treas. Regs. 451-1(a) states that under the accrual method of accounting, income must be recognized in the taxable year in which taxpayer's right to the income is established and the amount can be reasonably determined. The interment date is a factor to be considered in determining when a sale is to be recorded. In some instances, interment occurs before any required downpayment is made. When this happens, the sale is consummated and has to be recognized.

Pre-need Sales - Installment Method

The sale of cemetery property had been held to be a sale of an interest in realty in the nature of an easement, thereby qualifying for the installment method (National Memorial Park, Inc. v. Commissioner, 145 F.2d 1008 (4th Cir. 1944), cert. denied. 324 U.S. 858 (1945)). The sale of mausoleum space has also been held to be an interest in realty, the sale of which is subject to the installation method. The portion of the sales price held as a perpetual care fund must be excluded in computing the contract price and gross profit (Community Mausoleum Co. v. Commissioner, 33 B.T.A. 19 (1935), acq., 1955-2 C.B. 4).

As part of the Tax Reform Act of 1986 Congress added Section 453C to the Internal Revenue Code. Under section 453C the existence of outstanding debt on the taxpayer could cause a portion of the debt to be recognized as payment of certain of the installment obligations outstanding. Section 453C was repealed by the Revenue Act of 1987. For dispositions of real property by dealers in property it was only applicable for the period after 2/28/86 and before 1/1/88.

The Revenue Act of 1987 likewise repealed the use of the installment method by dealers. Section 10202(e)(2)(B) of the Act disallowed the use of the installment method of accounting to all sales in taxable years beginning after 1987. Section 10202(e)(2)(B)(ii) of the Act decreed that any change in accounting method necessitated by the deletion of the installment method would be treated as initiated by the taxpayer and approved by the Secretary.

Any gains which remained on installment obligations which were entered into prior to January 1, 1988 and after February 28, 1986 will be taken into account as a Section

481(a) change of accounting method adjustment over a period not to exceed four years. The period of time for inclusion under 481(a) cannot exceed the original time for inclusion in income under the original installment sale contract.

A typical pre-need sale contract consists of ten percent down with the balance due over 60 equal monthly installments. The first 25 percent of the money received is paid to the salesman as his commission or salary. Since the repeal of the installment method, the cemetery was confronted with the prospect of having to report the profit from the pre-need sale of cemetery property at the time of sale while the initial cash flow was being paid to the salesman. The resulting cash squeeze caused the cemeteries to explore new avenues in the reporting of income.

Percentage of Completion Methods

The 1984 Tax Act had also added Section 461(h) to the Internal Revenue Code which denied taxpayers using the accrual method of accounting from taking deductions for expenses until economic performance occurs. This would mean that for sales of pre-need property which was not completed at the time of sale the income would be included but the costs to complete would only be allowed as they were actually incurred.

The 1986 Tax Reform Act added Section 460 to the Internal Revenue Code which provided that the income from long-term contracts was to be reported under either:

1) Percentage of completion-capitalized cost method or

2) Percentage of completion method.

The percentage of completion-capitalized cost method basically allowed the taxpayer to report a portion of the income under the percentage of completion method and a portion under the taxpayer's normal method of accounting.

The percent to be reported under each method has been adjusted by subsequent tax acts as follows:

	Percentage-of -Completion	Percentage-of -Completion Capitalized Cost
1986 Tax Reform Act	40%	60%
Revenue Act of 1987	70%	30%
Technical and Miscellaneous Revenue Act of 1988 (TAMRA)	90%	10%
Revenue Reconciliation Act of 1989	100%	0

The Internal Revenue Service issued Notice 89-15, 1989-7 I.R.B. to provide guidance to all taxpayers with respect to changes to the long term contract rules initiated by Technical and Miscellaneous Revenue Act of 1988.

The notice, through a series of questions and answers is a discussion of long term contract accounting under Section 460. The notice is an excellent aid in the understanding and application of the percentage of completion method to long term contracts and should be reviewed if Section 460 is being reviewed on a cemetery or any other entity. The notice is an administrative pronouncement described in Regulations Section 1.666-3(b)(2) and can be relied on the same as a Revenue Procedure or Revenue Ruling.

The notice, as well as the Regulations, define a long term contract as any contract for the manufacture, building, installation or construction of property if the contract is not completed within the taxable year in which it is entered into. A contract for the manufacture of property is not, however, considered a long term contract unless the contract involves either:

1) A unique item of a type that is not normally included in the finished goods inventory of the taxpayer.

2) An item that normally requires more than 12 months to complete.

These limitations do not apply to contracts for the building, installation or construction of property. A contract for the building, installation or construction of property which is not completed within the year which it is entered into is considered a long term contract.

The notice defines a taxpayer's "normal" method of accounting as the method used to account for long term contracts immediately prior to enactment of IRC Section 460. For cemetery pre-need plot sales this was the installment method. The notice further states that if the taxpayer is required to change their method of accounting by law or has obtained the consent of the Commissioner to change their method of accounting, the new method is to be considered their "normal" method.

The repeal of the use of the installment method by dealers by the Revenue Act of 1987, also treated any change in accounting method as necessitated by the law change as initiated by the taxpayer and consented to by the Commissioner.

Since the taxpayer was allowed to select a new method of accounting to account for contracts which had been accounted for by the installment method, and since the construction of the cemetery lawns was not completed in the year in which the construction begins, many cemeteries have begun to use the percentage-of-completion method to report the income from them.

The 1986 Tax Reform Act allowed an exception to the use of the long term contract method of accounting for what were termed small construction contracts. These were contracts which took less than two years to complete and where the average annual gross receipts of the taxpayer for the three taxable years preceding the taxable year in which the contract was entered into, did not exceed $10 million. Since most large cemetery lawn construction (involving lawn crypts) take in excess of two years, this exception does not apply in many cases.

After the 1986 Tax Reform Act many cemeteries began to report the sale of cemetery plots under one of the following methods:

1) At need sales - Accrual Method (see above).

2) Pre-need sales - (Each discussed below).

Percentage-of-Completion

Pre-need Sales in Lawns to be Constructed or Under Construction

The percentage of completion method appears to be a proper method of computing the amount of income to be included from the pre-need sale of cemetery property as long as the construction contract extends beyond the year end and the property is not completed at the time the contract is consummated. This would also appear to be applicable to the construction and sale of mausoleum space.

The computation of the income to be included and the expenses allowed should be broken down to a per plot basis with the percent of completion applied only to the plots which are sold and only the costs applicable to the plots sold being deducted. As additional plots are sold in subsequent years when the lawn is nearer to completion, a higher percentage of a plot's sales price would be recognized as income with the actual associated costs being deducted.

The total costs applicable to a plot would be a proportionate share of all the development costs (including land) of a cemetery lawn as previously discussed.

The pre-need contract price for the plot should only be for the plot and crypt (if it is a pre-constructed integral part of the plot as described above). The fee for opening and closing the grave was found to be charged at the time of need. If it was a part of the pre-need contract, it would appear to be includible in income under economic accrual. When items such as marker, marker setting fee, flower container, flower container setting fee were included in the pre-need contract they were reported on the economic accrual method, as it appears they should be. They were not part of the long term contract. Since these items would not be delivered until some undetermined future date, no deduction should be allowed until all events have taken place to fix the liability (including the economic performance rule of Code Section 461(h), i.e. buying the marker).

Items such as endowment care of the cemetery and the marker would be placed in the endowment care trusts, therefore no income would be recognized. However, they should be the last dollars collected. If the cemetery lawn is one in which the vaults are to be individually set at the time the lawn is being completed, it would appear that the vault liner is a part of the contract of sale and its cost would be included in the percentage of completion computation. If it is only to be installed at the time of need or at the end of a period of years some time after the lawn is finished, it can be argued that it should be reflected in income under the economic accrual method.

If a sale is reported under the percentage of completion method and the customer later becomes delinquent in his or her payments, the cemetery cancels the contract and keeps virtually all of the payments made. The cemetery usually reverses the entire sale on its books and reassigns the money kept to forfeiture income.

Pre-need Sales in Finished Lawns

The pre-need sale of a plot in a previously finished lawn of a cemetery would not qualify for the long term contract method of accounting, however, some cemeteries are treating the pre-need sales in these lawns as long term contracts if the individual vault liner still needs to be installed. The contract usually requires the vault to be installed within five years, or at time of need, whichever comes first.

Although the cost of the vault liner is approximately $200-$250, it can be a substantial part of the cost of a plot in an older cemetery which has been completed for some time. The installation of the vault liner takes approximately two-four hours since it is done by a backhoe. It would appear that the time required to install the vault liner is insignificant in relation to the time required to complete the cemetery lawn and would not justify the use of the long term contract method for reporting income.

Advance Payments - Finished Lawns

If the amounts received were required to be placed in a trust and not available to the company, it would appear that they would not be includible in income until such time as they did become available. Rev. Rul. 87-127, 1987-2 C.B. 156, superseding Rev. Rul. 73-140, 1973-1 C.B. 323.

BOOKS AND RECORDS

Cemetery books were found to conform to generally accepted accrual sets of books, including the following:

1) General Ledger
2) Accounts Payable Journal
3) Accounts Receivable Journal
4) Cash Disbursement Journal
5) Sales Journal
6) General Journal
7) Payroll Journal

Records and workpapers consist of the following:

Income

1) Separate contracts for at-need and pre-need sales (see samples at Exhibit 7-1 and 7-2). Sometimes when the cemetery was related to a mortuary, one contract was used for both mortuary and cemetery parts of the transaction.

2) Cancellation notices written up for the pre-need contracts cancelled due to lack of payment.

Cost of Goods Sold and Expenses

1) Contracts for design and building of lawn crypts, mausoleums, columbariums, roads, curbing and walkways, landscaping, sprinklers, lighting, drainage, sod, features and other structures.

2) If the percentage of completion method is used, a schedule setting forth the estimated total cost of the project at the end of each year along with a schedule

showing the total actual costs incurred to date.

A schedule computing the percent of completion of the lawn based on the schedules above, and the application of the percent of completion to the total sales price of the grave sites sold.

3) Invoices pertaining to the actual work performed on the above contracts as well as all other expense items on the return.

POTENTIAL AUDIT ISSUES AND SUGGESTED AUDIT PROCEDURES

Examinations of the cemetery cases resulted in adjustments to items which can be classified as common to all tax cases (T&E, use of auto, excessive director fees, accounting errors). The items below are particular to the industry, however, normal audit judgment and procedures should be applied to any accounts which the agent identifies as unusual or excessive.

Each of the issues is discussed in the following context as pertinent.

1) Discussion of the issue.
2) Records to review.
3) Suggested audit steps.

Profit and Loss Statement

Income-General Discussion

As discussed previously, cemetery returns reported income from the following sources:

1) Sale of ground interment spaces, lawn crypts, mausoleum spaces, niches on an at-need and pre-need basis. Reporting of these sales on the return may be on the accrual or percentage-of-completion long term contract method.

2) Sales of merchandise which may consist of:

   a) Vault liners (outer burial container).
   b) Markers or headstones.
   c) Flower holders.
   d) Flowers.

3) Sale of services which may consist of:

   a) Cremation.

  - b) Fees for setting the vault liner, marker, headstone and flower container.
  - c) Interment and recording fees.

4) Income from the endowment care trusts if the cemetery is an endowment care cemetery.

5) Miscellaneous income which may consist of:

  - a) Forfeiture income earned as a result of the failure of customers to keep payments current on pre-need interment property purchased on a payment schedule (sale and cost of goods sold entries are reversed and the funds previously received are reclassified to forfeiture income).
  - b) Interest on bank accounts, dividends from investments.

<u>Suggested Audit Steps-Income and Cost of Goods Sold</u>

1) Determine in the initial interview if the cemetery sells plots on the at-need and pre-need basis.

2) Determine the method of accounting used by the taxpayer to record the building and sale of the cemetery plots. Installment method should not be used for years beginning after 1987.

3) If the percentage of completion method of accounting is used, is it applied to lawns under construction or also for lawns which require no additional work other than the installation of the individual vault liner. If it is used for lawns previously completed, consider adjustment to convert these sales to the accrual method since they do not appear to be long term contracts.

4) For sale of plots in lawns under construction which are reported on the percentage of completion method:

  - a) Review the schedule of total estimated cost to complete the cemetery lawn for reasonableness. Have the taxpayer provide explanation of how the estimated totals for various phases were arrived at.
  - b) Review the actual costs incurred for the year.
  - c) Determine that the estimated and actual costs have the Section 263A costs and production period interest capitalized. These costs were found not to have been capitalized in audits performed.
  - d) Determine that the percentage of completion at the end of the year is only applied to the units which have been sold and that actual costs deducted are only the portion applicable to the plots sold.
  - e) Use a judgment sample to determine if other expense accounts on the return include items which should be part of the long term contracts.

5) Inquire as to whether the taxpayer has completed any long term contracts during the taxable year. If so, determine if Form 8697 (Interest Under the Look-Back Method for Long-Term Contracts) was filed.

   Note: If the percentage-of-completion method is used, refer to CPE training book 3147-804 (7-89) Chapter 14 (Long-Term Contracts) and Chapter 15 (263A) for a general overview.

6) If the cemetery is reporting sales of property on the accrual method, have the company explain how and what costs are accumulated in the inventory of unsold graves, and how they costed out (average cost per plot per lawn). Determine not only that the cost of the cemetery lawn is capitalized, but that if a new lawn has been constructed (which may have required the purchase of new land at substantially higher cost), that the cost per grave is allocated respectively, and that sales in each lawn have their own respective cost per plot expensed.

7) If pre-need sales contracts included the sale of such things as markers, determine that they are reported on the accrual method and not included in the long term contract method.

8) Perform general audit tests as deemed necessary to verify sales and cost of goods sold such as:

   a) Sales and purchase cutoff.
   b) Test sample of contracts to sales journal.
   c) Review of all large debit entries to sales.
   d) Bank deposit analysis (small cemeteries).
   e) Test of purchase contracts and invoices.
   f) Review of all year end company and audit journal entries.

9) While there were no incidents of unreported income on cemeteries examined, if a suspicion exists, the agent may attempt to uncover unreported grave sales through review of the following:

   a) The cemetery endowment care fund report (Form 27M-7) required by the State Cemetery Board (California). This report requires the cemetery to report to the state board among other things, the number of square feet of grave space and the number of crypts and niches sold or disposed of under endowment care for the year ended of the company.
   b) The annual license renewal form sent to each crematory yearly. The form requires the reporting of the number of cremations performed. If the crematory does not provide this form, the state board will provide this information to the agent.
   c) Secure copies of reports summarized by Vital Statistics for the period in

question.

10) If this is an endowment care cemetery, review the endowment care trust tax return and determine that the distribution is picked up on the cemetery return. If the cemetery did not set up a trust, but separated the funds, determine that the income is reported on the cemetery return. If the endowment care trust is audited, review the requirements of Section 642(i) as discussed in this guide.

Expenses

Related Entities Expenses - General Discussion and Audit Suggestions

Cemeteries who have related mortuaries may share not only the location but also the same expense items. The issue of allocation of expenses between related entities surfaced in each of the audits where a taxable cemetery and mortuary were related, or where a mortuary was owned by a tax exempt cemetery. If the cemetery is a tax exempt cemetery, the allocation problem could be of greater concern in that the exempt organization has no need for expenses since its income is not taxed. Also, one taxable cemetery audited had a large net operating loss while its related mortuary had a sizable profit. In the examinations performed, allocation adjustments for bad debt expense, advertising expense, and salaries expense were proposed. Each of these items pertain to mortuaries as well as cemeteries, and were discussed at the mortuary section discussing potential audit issues.

Personal Use of Dwelling Structures - General Discussion and Audit Suggestions

Instances were found where cemeteries had dwelling structures located on the grounds which were being depreciated while being used as personal residences for owners or other family members. Companies should be questioned as to dwelling structures and their occupancy. Review of the fixed asset schedule may also reveal their existence.

Exhibit 7-1 (1 of 2)

SAMPLE OF CONTRACT FOR AT-NEED CEMETERY AND MORTUARY SALE

XYZ Memorial Park/Mortuary
1000 Underground Ave.
XYZ, California 90000

This is an Endowment Care Interment Property No.___________

Date:_________ Deceased:_____________________________

Deaceased Person Relative:____
Address:____
City:___________________ State:_________ Zip:_________ Phone:_____________

I agree to purchase the following cemetary and mortuary goods and services as itemized below:

Cemetary Services

Section_________Map#_____________Lot/Block#______________Space#____________
Crypt:_______Lawn Crypt:________Wall Crypt:__________Garden Crypt:_____________
Niche:___________Mausoleum:______________Cremation & Processing:______________
Mortuary:__________City:_______________Chapel/Church_________________________
Time of Service:__________________ Date of Service:____________

Service		**Price**	**Total**
Crypt, Lawn Crypt, Space, Niche		$ ________	
Endowment Care	________		
Cremation & Processing	________		
Urn		________	
Memorial Tablet		________	
Setting		________	
Endowment Care	________		
Interment & recording fee		________	
Outer Burial Container		________	
Setting		________	
Flower Container	________		
Setting		________	
Flowers		________	
Saturday Service Charge	________		
Others		________	
Sales Tax		________	
Cemetary Total		$ ________	

Page 1 of 2

Exhibit 7-1 (2 of 2)

SAMPLE OF CONTRACT FOR AT-NEED CEMETERY AND MORTUARY SALE
(continued)

Mortuary Service Charge

Minimum Service Charge $ _______
Securing Permits _______
Transfer of Remains to Mortuary _______
Embalming or Refrigeration _______
Transportation _______
Preparation of remains for viewing _______
Counseling and Staff Time _______
Obituary _______
Additional Evening Services _______
Pallbearers _______
Hearse _______
Flower Carrier _______
Casket _______
Shipping Container _______
Clothing _______
Memorial Book _______
Memorial Folders _______
Acknowledgement Cards _______
Prayer Cards _______
Crucifix _______
Rosary _______
Other _______
Merchandise Tax _______

Cash Advance

Permit Fee $ ______
Minister ______
Music ______
Vocalist ______
Motor Escort ______
Certified Copies ______

Cash Advance Total ______

Mortuary Total $_________
Cemetary Total $_________
Cash Advance Total $_________
Total $_________
Cash Payment $_________
Other Credit $_________
Balance $_________

I agree to pay in full the balance due hereunder within 60 days of the date of this contract. If I fail to pay by this date, it is agreed that the company will be damaged in an amount difficult to determine and therefore, I agree to pay a late charge of 1% per month from the date of the agreement on the unpaid balance as a reasonable compensation for such damage plus all costs of collection legal fees, and expenses of litigation and arbitration.

You the purchaser may cancel this contract at any time prior to midnight of the fifth calendar day after the date of this transaction, provided no interment or substantial service or merchandise has been provided hereunder. To cancel, deliver or mail written notice of you intent to the company.

Representative Name________________________________Date___________________________
Signature____Date___________________________

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Exhibit 7-2

SAMPLE OF PRE-NEED FUNERAL SERVICE CONTRACT

XYZ Memorial Park/Mortuary Inc.
1000 Underground Ave.
XYZ, California 90000

Pre-Need Interment Property Purchase Agreement

Name of Buyer______________________________ Contract No._______________
Address____________________________________
City_______________________________________ Social Security
State________________Zip Code_______________ Number___________________

This agreement made this ________day of_________,19___,between XYZ Memorial Park Inc. hereinafter referred to as Seller, and_________________________hereinafter referred to as Buyer.

I agree to buy the property described below from XYZ Memorial Park Inc.

Grave Number___________
Lot Number_____________
Section Number__________

— —

1) Gross Property Price _____________
2) Pre-Developed Discount _____________
3) Exchange Credit _____________
4) Net Property Price _____________ (4=1-2&3)
5) Endowment Care Fund _____________
6) Cash Price _____________(6=4+5)
7) Cash Down Payment _____________
8) Other Down Payment _____________
9) Amount Financed _____________(9=6-7&8)
10) Finance Charge _____________

11) Total of Payments _____________(11=9+10) _______.

DOES NOT INCLUDE
FUNERAL SERVICES
OR INTERMENT FEE

Payment to made as follows:
Number of Payments________
Amount of Payments________

Payment is due monthly on the ____day of each month beginning___

— —

(A)	(B)	(C)	(D)	(E)
Annual Percentage Rate The cost of your credit ona yearly rate.	Finance Charge The dollar amount your credit will cosr you	Amount Financed (unpaid balance) The amount of credit provided to you or on your behalf	Total of Payments The amount you will have paid after you have made payments as scheduled	Total Sale Price The total cost of your purchase on credit, including credit and your downpayment of $_____
_________%	$___________	$___________	$___________	$___________

The Buyer agrees that he (or she) has read this Agreement and that he (or she) understands its terms and conditions, and that there are no covenants, conditions, warranties or representations other than those contained herein. The Buyer hereby acknowledges receipt of a copy of this Agreement.

On payment in full for the property a Deed of Ownership will be issued as follows:

Buyer's Signature_______________________________________Tel. No.______________________________
Home Address________________________________City________________State_______________Zip_____

Section 8

SYNOPSIS OF RULINGS AND COURT CASES PERTAINING TO THE INDUSTRY

Attached are a listing of Revenue Rulings, Revenue Procedures, Letter Rulings, Notices, Technical Memorandums and court cases pertaining to the mortuary and cemetery industry. At the time of writing the rulings and memorandums do not appear to be superseded. Additional cases can be located and updated using the services such as the CCH or Prentice Hall Citator and PhiNet.

REVENUE RULINGS

RR 58-190

The ruling sets forth the following determinations from situations presented:

1) A for profit cemetery is not required to include in gross income amounts which are irrevocably set aside in trust solely for the perpetual care and maintenance of the cemetery if the amounts so set aside are pursuant to:

    a) State law or,
    b) Its own by laws/contracts. Amounts must be set aside to be excludible.

2) An organization including a trust set up to provide for the perpetual care and maintenance of a non-profit cemetery, none of the earnings of which inures to the benefit of any private shareholder or individual, may qualify as a tax exempt organization under Section 501(c)(2) of the IRC.

3) Voluntary donations to or for the use of a non-profit cemetery company or corporation, the funds of which are irrevocably dedicated to the perpetual care and maintenance of the cemetery are deductible by the donors as charitable contributions to the extent allowed by Section 170(c)(5) of the IRC.

4) Payments to a cemetery which constitute a part of the purchase price of a burial lot or mausoleum crypt and are irrevocably dedicated to a perpetual care fund are not deductible as a charitable contribution.

5) Funds received by a cemetery company for the care and maintenance of an individual plot or crypt create a trust subject to tax under Section 642 of the IRC.

6) Trust income which is used for the care and maintenance of a particular plot or crypt is not allowed as a deduction under Section 642(c) of the IRC.

RR 61-137

A new organization purchased cemetery land on which to operate a non-profit cemetery. The sales price of the land was not fixed but instead the seller was to receive a percent of the selling price of each plot. The Service ruled this would result in a benefit to the seller and the exempt status was denied.

RR-64-109

A cemetery company will be subject to the loss of its exempt status if it operates a mortuary.

RR-64-217

Determines that a perpetual care fund which turns its income over to a for-profit cemetery for the care and maintenance of the cemetery is not exempt from income tax under Section 501(c)(13) of the IRC. It was deemed that the services and facilities furnished by a perpetual care fund to a cemetery operated for profit constitute substantial assistance in its business and financially inure to the benefit of the profit company or its shareholders.

RR 65-6

An organization owned, operated and maintained a cemetery in which only members of a family, descendants and intermarried descendants could be buried. The cemetery was supported by assessments and contributions by members. Ruling held this was not a tax exempt organization and no charitable deduction was allowed.

RR 69-256

Determines that a trust set up to make donations to charitable organizations as well as to maintain the testers burial lot was not a tax exempt trust under Section 501(c)(3) of the IRC since it inures a benefit to the grantor instead of solely to the public interest. Reference is made to RR 58-190.

RR 69-637

Withdrawn by RR 71-300.

RR 72-17

Exempt status of a cemetery was not affected by the sale of monuments, markers, vaults, and flowers solely for use in the cemetery with the use of the sales proceeds for maintenance of the cemetery.

RR 73-454

A cemetery organization which owns, operates and maintains a cemetery for pets is not a tax exempt organization.

RR 77-70

A newly incorporated non-profit corporation entered into a stock purchase agreement with a for-profit cemetery company. The former shareholders were to receive 30 percent of the selling price of each lot sold on the property thus acquired. The agreement was to continue until all lots were sold. The Service determined that the cemetery was not a tax exempt organization under Section 501(c)(13) listing the following reasons:

1) There was no unqualified obligation by cemetery to pay.

2) No maturity date exists - sales continue until all lots are sold.

3) No sum certain - price of lots is subject to change.

4) No stated interest rate.

5) No annual payment.

6) No right to share with general creditors.

7) There was no paid in capitalization of the company.

8) The transferrers have control of the cemetery company.

RR 78-143

A non-profit organization created by citizens of a community to provide the care and maintenance of a burial area containing the graves of persons who had lived in the community, the lot's owners and paupers, was determined to qualify as tax exempt. There is no cemetery company involved.

RR 80-97

An unrestricted contribution to a cemetery company exempt from federal income tax under Section 501(c)(13) of the IRC but not described in Section 170(c)(2)(B) made by a private foundation under Section 509(a) was determined to be a taxable expenditure within the meaning of Section 4945(d)(5) and not a qualifying distribution within the meaning of Section 4942(g).

RR 87-97

Funds distributed by a perpetual care trust fund to a cemetery corporation for the care and maintenance of gravesites are compensation for services taxable to the cemetery corporation under Section 61 of the Code.

RR 87-127

The purchasers of pre-need funeral services, rather than the sellers, are the grantors and the owners of pre-need funeral trusts established under state laws. Any money received from the trust by a seller of a pre-need funeral is a payment for merchandise and services includible in the seller's gross income under Section 61 of the Code. (Rev Rul 73-140 superseded.) The ruling describes four different pre-need arrangements and, pursuant to Section 7805(b), the ruling holds that the findings are only applicable to certain of the situations for certain dates.

REVENUE PROCEDURES

RP 71-21

Accrual method taxpayers are allowed in certain specific and limited circumstances to defer the inclusion in gross income for taxable purposes, of payments received in one taxable year for services to be performed by the end of the next succeeding taxable year.

NOTICES

89-15

This notice provides guidance with respect to changes made to the rules for long-term contracts made by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). The notice consists of a series of questions and answers that cover the definitions of a long-term contract, the effective date of Section 460, rules for determining whether the percentage of completion or percentage of completion-capitalized cost method is to be used, and the rules for determining which costs are allocable to a long term contract and, therefore, taken into account under Section 460.

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Leonard Ruck, Inc. v. Comm., TC Memo 1969-16, CCH 29,426.

SYNOPSIS OF COURT CASES

Acacia Cemetery Park v. Comm. 3 USTC P 1177. affirms 27 BTA 233

Cemetery corporation sold plots under purchase agreement stating the purchase price included perpetual care. Ten percent of the selling price of the lots was to be placed in perpetual care fund, the income was to care for cemetery. The cemetery did the following:

1) Deposited $6,500.00 into a trust fund.

2) Agreed to make future deposits into the fund.

3) Agreed that the income should be used for perpetual care.

4) Agreed that any excess would be returned to the corporation for corporation use.

In determining the price of the lots as costed on the cemetery return $200,000.00 was included as an amount intended to be set aside for perpetual care.

The court found:

1) That the $200,000.00 was not includible in the cost of lots since the money had not been paid to the trust.

2) The entire amount set aside in the trust was taxable to the company since the cemetery:

    a) Failed to properly create the trust it had promised.
    b) Used the funds for other purposes than that it contended.

<u>Angelus Funeral Home v. Com. 69-1 USTC, 9216, Ct of Appeals, 9th Circuit, 2/10/69, Affirming Tax Ct, 47 TC 391, Sup. Ct cert. denied 396 US 824, 90 S. Ct 65</u>

The funeral home collected funds from prospective customers under two forms of written contracts, each denominated, "Pre-Need Funeral Plan Agreement." The earlier form created a trust but the later one did not. Under the terms of the later agreement, the funeral home could use the funds as it desired. These amounts were determined to be taxable income to the funeral home when reviewed.

<u>Arlington Memorial Park Ass'n (DC) 71-1 USTC P9393, 327 F. Supp 344)</u>

An incorporated association which was comprised of the purchasers of burial plots was denied tax exempt status since it did not carry on the functions of a cemetery. Money had been transferred to the association by its sister corporation (a realty company) to be accumulated in an endowment care fund to care and maintain the cemetery. The actual operation and care of the cemetery was done by the realty company, a for-profit company. The association had no employees and the only activity was to hold annual meetings. No money from the trust was ever turned over to the realty company to pay for care of the cemetery.

<u>Albuquerque Nat'l Bank. Tr. (Sunset Memorial Park Trust) v. U.S. 2/14/75. DC Mex. 35 AFTR 2d 75-951. 75-1 USTC P9294</u>

Land Company, a cemetery company, operated for-profit, furnished funds to a trust which in turn passed the income to an incorporated association which cared for and maintained the cemetery. The association had no taxable income and was not a party to the action. The trusts application for tax exempt status had been denied by IRS, taxes paid on capital gains and claims for refunds filed.

The Court decided that the trusts did not qualify as tax exempt organizations because:

1) The trust activity through the association indirectly inured to the benefit of the for-profit Land Company or its shareholders.

2) The trusts in and of themselves did not operate as a cemetery, as required by Section 501(c)(13) of the IRC.

The taxpayer relied heavily on the findings in the Resthaven Memorial Park case (see synopsis). The court pointed out that the cases decided since Resthaven reflect that the courts are taking a more discerning view of the specific arrangements of the particular "cemetery company" in question.

American Cemetery Corp. v. U.S. 28 Fed (2d) [1928 CCH P8326]

Taxpayer is required by state to set aside not less than ten percent of the purchase price of each burial lot for the permanent maintenance of the cemetery. Taxpayer set up an irrevocable trust to which payments are made until the sum of $2,500 per acre is reached. Trust company will pay to taxpayer income from the trust necessary for the care and maintenance of the cemetery. Any amount not necessary for the maintenance of the cemetery will be retained by the trustee.

Court ruled for taxpayer in that amounts paid to trustee is not taxable income because the trust is irrevocable and the principal and income is beyond the reach of the taxpayer.

Butler County Memorial Park, Inc. 45 TCM 181. Dec. 39.518(M), TC Memo 1982-678

Butler County Memorial Park, Inc. was a tax exempt cemetery company which was owned by a couple (Landroffs). They sold their shares in the corporation along with a total of 61.319 acres of land adjacent to the cemetery to another couple (Jordans) for $113,378.00. The Jordans then transferred the 61.319 acres to the cemetery corporation.

Briefly, the government contended that the Landroffs had sold their stock at book value and had, therefore, made a gain on the sale of the cemetery stock which was an impermissible inurement of value of the corporation's net earnings within the meaning of Section 501(c)(13) of the IRC. The government revoked the tax exempt status of the corporation.

The court found that the government had erred, the land transferred to the Jordans was owned by the Landroffs and not the corporation and that the $113,378.00 was a value assignable to the land, not the corporate stock. The court determined that the stock was transferred for a nominal value, therefore, the tax exempt status had not been violated. The court found for the taxpayer.

C. Harry Blunt v. Commissioner. TC Memo 1966-280, 28-295

Various issues were litigated, of which only the gross receipts understatement will be discussed. Emphasis is on the method in which the understatement was determined and the type of books and records kept by taxpayer which may be encountered by agents in an audit of this type of taxpayer. Taxpayer operates a sole proprietorship mortuary. Taxpayer maintained three separate means of recording income. They were:

a) First-call booklets -- details of a particular transaction is recorded in this book initially and in chronological order of the date of death. This book contains descendant's personal information and the itemized charges such as casket, clothing, embalming, automobiles, taxes, advance payments and the date and amount of payments/credits made.

b) Funeral records card -- all information from the first-call booklets is transferred to this 5" x 8" index card. This card is filed in alphabetical order to make it easier to locate a particular funeral which could not be done using the first-call booklet unless the approximate date of death is known.

c) Ledger journal (entitled Rex Tax Record for Funeral Directors) -- this was designed to record receipts on one side and expenses on the opposite page. Expense side had columns to show check number, date paid, payee and description of expense. Receipts per this journal were deposited to the checking account and expenses were drawn out of this account. Taxpayer was the only one who made entries into this book and presumably took information from the first-call booklet and/or the funeral card. This book was used by taxpayer in preparing tax returns.

An item by item comparison of the gross receipts per the first-call booklet with the funeral records card showed that except on isolated occasions, they were identical. A comparison of the funeral record cards with the ledger journal and the bank deposits showed receipts were either omitted or understated in the ledger journal. Court upheld the IRS determination.

Commissioner v. Cedar Park Cemetery 50-2 USTC P9376, 183 F. 2d 553 (7 Cir) (1950)

Issue 1

The court determined that amounts set aside by a cemetery company into a perpetual care trust to be used solely for the care and maintenance of the cemetery were properly excludible from the gross income of the cemetery company. The discussion revolves around the validity of the trust and the actual setting aside of the money.

Issue 2

The court determined that the basis of cemetery lots sold in one section of the cemetery was not to be reduced by the excess of costs mistakenly and inappropriately included in the cost of another section of the cemetery previously expensed and on which the statute of limitations had expired.

Commissioner v. Kensico Cemetery, 38-1 USTC P9283, 96 F.2d 594 (2d Cir. 1939)

A cemetery corporation organized as a not-for-profit corporation under New York laws acquired land by issuing land-share certificates and agreeing to pay to the holders of such certificates one-half of the amount realized from the sale of grave space. The government contended that corporation was organized and operated for the benefit of the land-share certificate holders.

The court held that the certificates represented a bona-fide debt due by the petitioner to the holders and as such no part of the earnings of the petitioner paid on the debt can be considered as earning inuring to the shareholders or individuals. The court allowed tax exempt status under Section 501(c)(13).

Note: Subsequent cases have not followed the reasoning in this case and instead have found similar arrangement to inure benefit to the shareholders or individuals.

Clark Trust, The Woodlawn Cemetery, Trustee v. Commissioner 49 TC 456

The Clark Trust was created to provide perpetual care for particular cemetery lots located in the Woodlawn Cemetery. The trust 1041 return was filed showing the trust to be a simple trust and claiming a $300.00 personal exemption. The trust reasoned that it was a simple trust, since it was required by its trust instrument and local law (New York) to distribute its income currently for the care and maintenance of the lots involved.

The court found that even though the trust was created for the care and maintenance of the lots, it was not mandatory that the funds be distributed and expended on a yearly basis. The court also did not interpret local law as requiring all current income to be distributed currently. The funds could be accumulated and expended when the need arose. It therefore determined that the trust was a complex trust and was entitled to a $100.00 personal exemption.

Denver United States National Bank as Trustee v. U.S., 65-2 USTC P9556

Denver United States National Bank was trustee of three trusts set up by Fairmount Cemetery Association (a for-profit Colorado corporation) to provide for the perpetual care and maintenance of the Fairmount-Riverside Cemeteries and Mausoleum. Income from the trusts was paid to the Association who commingled it with other funds but did use it for the care and maintenance of the properties.

The trusts, by their terms, were not required to distribute the capital gains income, but it was instead to become part of the corpus of the trust.

The court concluded that the trusts were entitled to tax exempt status with the following reasoning:

1) The income of the trusts involved were irrevocably committed to the care and maintenance of the cemeteries and mausoleums and could be used for no other purpose.

2) Providing care of the cemeteries and mausoleums was a cemetery function and the trusts here involved are cemetery companies within the purview of IRC Section 501(c)(13).

3) The Association is not deemed to be a beneficiary of the trust.

4) Payment of the income of the trust to the Association is deemed to be in the nature of compensation for services rendered to the trusts for the care and maintenance of the cemeteries. No part of the corpus of the trusts can inure to the benefit of the Association or its stockholders.

5) The trusts are not operated for profit.

Du Pont de Nemours Cemetery Co. 33 TCM 1438, Dec. 32.884(M), TC Memo 1974-314

A family cemetery company was found to be a exempt organization under IRC Section 501(c)(13).

The Du Pont de Nemours Cemetery Co. is a family cemetery company in whose cemetery burial is restricted, with minor exceptions, to the descendants of Pierre Samuel duPont. The court rejected the idea presented by the government that in order to qualify under Section 501(c)(13) a cemetery must be "public." The court deemed that the company qualified as a company owned and operated solely for the benefit of its members (only one of the three tests under Section 501(c)(13) must be met to qualify).

Endowment Care Trust Fund of Inglewood Park Cemetery Association Board of Trustees v. U.S., 76-2 USTC P9516

Court determined that a trust fund set up to receive a percentage of grave sale and to care and maintain for the Inglewood Part Cemetery, a for-profit cemetery was not tax exempt. It took on the same tax statute as the association.

Epstein TCM 1964-192

An allocation of purchase price to covenant not to compete was disallowed when the seller was 74 years of age, almost totally blind and suffering from a heart condition.

Evergreen Cemetery Association and the Kentucky Trust Company, Plaintiffs v. U.S. Defendants 74-1 USTC P9285

Evergreen Cemetery Company (Cemetery), a for-profit cemetery, conveyed land it had acquired for a cemetery to the Evergreen Cemetery Association under an agreement which operated as follows:

1) Cemetery would sell lots and embellish and plot the grounds of the cemetery. Cemetery would keep 90 percent of the funds received on sales and ten percent would be transferred to Association to be set aside in a perpetual care fund. The split was later changed to 95 percent - five percent then to 92 1/2 percent - seven 1/2 percent.

2) The funds set aside in the perpetual care fund were to be originally reinvested until such time that the fund reached $500,000.00. This was later reduced to $300,000.00. Up through the years in dispute, no payments were made from the perpetual care fund.

3) The Association owned the land in fee simple and approved all the plans for development of the cemetery.

The court found:

1) That the Association was not a tax exempt organization under Section 501(c)(13) of the IRC since it did not perform enough vital functions for the cemetery in order to qualify.

2) The services performed were not consider "essential" to the maintenance of the cemetery as stated in RR 58-190.

<u>Evergreen Cemetery Ass'n of Seattle v. U.S., 71-2 USTC 9535 affirming 70-1 USTC 9127, 444 F2d, affg 302 F. Supp 720</u>

A perpetual care trust set up to provide perpetual care and maintenance to a for-profit cemetery corporation was not determined to be a cemetery company and thus was not tax exempt.

<u>First National Bank of Waco, Trustee of Waco Memorial Park Perpetual U/A. 71-1 USTC P9361, U.S., 327 F. Supp 1119</u>

A perpetual care fund set up and operated to provide perpetual care and maintenance of a for-profit cemetery was determined not to be exempt from tax. It was deemed to be a functional part of the for-profit cemetery and therefore no deduction was allowed. The principle is set forth that a perpetual care fund operated in conjunction with a for-profit cemetery is not exempt from tax while a perpetual care fund operated in conjunction with a tax exempt cemetery is exempt from tax.

In addition, capital gains realized by the perpetual care trust were not excludible from the trust taxable income as being permanently set aside for charitable purposes.

<u>Forest Lawn Memorial Park Association, Inc. v. Comm 45 BTA 1091 (1941) Dec. 12.222 (Nonacq. see 1960-2 C.B. Pg. 8)</u>

The case is a determination of whether or not the association above was a cemetery exempt from tax under Section 103(5) of the Revenue Act of 1932 and Section 101(5) of the Revenue Acts of 1934 and 1936. (These sections are identical to Section 501(c)(13) of the 1954 Internal Revenue Code.)

The service contended that the association was not exempt since its operation entailed the operation of a mortuary business on the cemetery grounds. The service contended that the mortuary business was not incident to the operation of a cemetery and that profits inured to the private shareholders.

The court in this case felt that the operation of a mortuary was incident to the operation of a cemetery. The court also reasoned that the operation of the mortuary at a profit was acceptable as long as the profits were used to improve the cemetery. (The government did not acquiesce to this case.)

<u>Forest Lawn Memorial Park Association Inc. 5 CM 738, Dec. 15.355(M)</u>

Note: Based on RR 64-109, the IRS proposed revocation of the tax exempt status of Forest Lawn Memorial Park in 1964 and again in 1975. To end the ongoing tax controversy, the organization offered to spin off its mortuary and flower operations into a taxable, wholly owned subsidiary corporation on December 31, 1979. The IRS accepted.

<u>Gardens of Faith Inc. v. Commissioner, 65-1 USTC P9324, 345 F.2d 180 (4th Cir. 1965), affg per curiam [CCH Dec. 26.866(M) 23 T.C.M. 1045 (1964) cert denied, 382 U.S. 927 (1965)</u>

Company was determined to be thinly capitalized. Payments made by the for-profit cemetery corporations on "certificates of indebtedness" which required them to pay the holders 25 percent of the base sales price of every burial lot sold by the corporations for 50 years, were not deductible as land costs but were instead dividends to the certificate holders.

<u>George H. Wilcox, Frances C. Wilcox v. Commissioner, Hugh E. Kennedy and Naomi Kennedy v. Commissioner, TC Memo, 1968-141, 29038</u>

The seller (Wilcox) treated the sale of the partnership interest in a funeral chapel as a sale of a capital asset whereas the buyer (Kennedy) allocated a portion of the purchase price as an amortizable cost for covenant not to compete.

<u>Graceland Cemetery Improvement Fund v. U.S. 75-1 USTC P9400</u>

The improvement fund was created under a special act of the Illinois legislature. It was a non-shareholding special charter Illinois corporation whose principal purpose was the perpetual care and maintenance of the Graceland Cemetery (a for-profit cemetery). Membership in the improvement fund corporation arose from ownership of a plot in the cemetery. The improvement fund received money as follows:

1) Ten percent of the sales price of lots sold by Graceland Cemetery Corporation.

2) Funds received through grants, bequests, or donations for the improvement and care of particular lots.

The improvement fund filed a corporation tax return reporting the above plus the income and gains and losses on investments. The corporate return filed claimed as deductions the following:

1) The 85 percent investment dividends received deduction available to corporations.

2) Deducted the depreciation on capital improvements made on property owned by it.

3) Deducted payments made for cemetery maintenance expenses and care of lot expenses.

The government determined that the funds received above were actually received by three non tax exempt trusts defined by the Service as follows:

1) "The Trustees of the Graceland Cemetery Improvement Fund - General" -- constituting a trust allegedly created for the investment of the ten percent proceeds from lot sales received from the Graceland Cemetery Corp.

2) "The Trustees of the Graceland Cemetery Improvement Fund - Marshall field Fund" -- a representative trust created as a result of contributions made under Section 9 of the special incorporation act.

3) "The Trustees of the Graceland Cemetery Improvement Fund -Lot Owners' Fund" -- constituting an association of all trust created by contributions and bequests made under Section 9, such as the Marshall Field Fund, and taxable as a corporation.

The court determined:

1) That the Graceland Improvement Fund is not a tax exempt organization since:

    a) It took on the same tax status as the organization which it serviced (Graceland Cemetery Corporation).

    b) It did not show itself to be a cemetery as per Section 501(c)(13) of the IRC.

2) The fund was a corporation as originally filed. The IRS trust concept was discarded.

3) Expenses relating to the care and maintenance of the Graceland Cemetery were allowed as ordinary and necessary.

4) Depreciation of property owned by the improvement fund and leased to the cemetery was allowed.

The court did not agree with the argument allowing tax exempt status to a similar organization in Denver United States National Bank as Trustee v. U.S., 65-2 USTC P9556.

Hagen Advertising Displays, Inc. 47 TC 139 (1966), aff'd 407 F.2d 1105 (CA-6 1969)

Court ruled that when advance payment is unrestricted, the right to income is unqualifiedly established and therefore should be recognized when received. No adjustment was made to cost of goods sold because Hagen made no argument that either its cost of goods sold or its ending inventories was incorrectly computed and Hagen's records did not compute separately that part of ending inventory that pertains to signs produced for those who paid in advance. Other court cases cited:

Automobile Club of New York, Inc., 32TC 906, 912-913 (1959) affd. 304 F.2d 781 (C.A. 2, 1962)

Fifth and York Co. v. US, 234 F. Supp. 421 (W.D. Ky. 1964)

Herbert Hatt v. Commissioner, The Albert Johann & Sons Company, Inc. v. Commissioner, TC Memo 69-229, U.S. Court of Appeals, 7th Cir. aff'g Tax Court

The court case addressed the following mortuary related issues:

1) Unreasonable compensation - Hatt became president and chief executive officer of Johann Inc. (a funeral home), following his marriage to Dorothy, the president and majority shareholder. He had no prior or formal experience or training in the funeral home business and is not and never was a licensed funeral director or embalmer. He only had five months of high school and his job experience ranged from delivering newspapers to sewing machine salesman. Maximum compensation deduction allowed to the Corporation was limited to the prevailing salary of funeral directors in the area.

2) Expenses for boat and airplane - Johann purchased a boat from Hatt and painted "Johann Funeral Home" on the boat. Johann also purchased an airplane which it never used in the business. IRS allowed Johann fifty percent of the claimed deductions for the boat as promotional expenses and disallowed portion was determined to be constructive dividend to Hatt. None of the expenses for the airplane were allowed and was determined to be constructive dividend to Hatt.

3) Lodging in the premises - Hatt lived in the apartment located in the funeral home building. Hatt answers the telephone when the office is closed and meets with customers who come after business hours. It is customary in the area, for the manager or another employee to live on the premises of a funeral home because the nature of the business requires someone to be in attendance 24 hours a day. Court allowed deduction under IRC 119.

J.D. Rockefeller Family Cemetery Corp., 63 TC 355, Dec 32.878(Acq)

A family cemetery company was found to be an exempt organization under Section 501(c)(13).

The J.D. Rockefeller Family Cemetery Corp is a family cemetery company in whose cemetery burial is restricted to the descendants of J.D. Rockefeller. The court rejected the idea presented by the government that in order to qualify under Section 501(c)(13) a cemetery must be "public".

The court deemed that the company qualified as a company owned and operated solely for the benefit of its members (only one of the three tests under Section 501(c)(13) must be met to qualify).

Kalamazoo Oil Co. TCM 1981-344, aff'd 693 F.2d 618, 82-2 USTC P9695.50 AFTR2d 82-6107 (CA-6 1982)

A retiring shareholder officer's covenant not to compete with his corporation, when the shareholder still held a controlling interest, was held not to have the value assigned to it since the covenant was a mere paper promise.

Knollwood Memorial Gardens, 46 TC 764, Dec. 28.118

Cemetery company was determined not to be tax exempt under Section 501(c)(13). Court did not agree with taxpayers reliance on Kensico Cemetery or Forest Lawn Memorial Park Association, Inc. (see listing).

Taxpayer paid 20 percent of the proceeds derived from the sale of grave spaces, to individual "land share holders" for the cemetery property acquired. Payments were deemed to be distributions made with respect to equity investment and not deductible land costs. The obligation to pay lacked the principal elements of debt. Taxpayer was not organized owned or operated exclusively for the benefit of its members, but for profit, with substantial profit going to the "land share holders" as lots were sold.

Laurel Hill Cemetery Association, Plaintiff v. United States of America, Defendant, 77-1 USTC P9212

Laurel Hill Cemetery Association was a corporation formed to provide care and maintenance of the Laurel Hill Cemetery. For the years under question the Laurel Hill Cemetery had changed hands and was being operated as a for-profit cemetery under the name Laurel Hills Memorial Gardens, Inc. The association for the years in dispute had filed fiduciary returns. The service assessed tax against the association as a corporation and allowed no deduction for amounts expended on the care and maintenance of the cemetery.

The court determined that:

1) The association was not tax exempt.

2) The association was taxable as a corporation and not a trust.

3) No deduction was allowed to the association for amounts expended on the care

> and maintenance of the cemetery since it could not be shown that the funds expended were used to solely care and maintain the cemetery. The association kept virtually no books and records. The Laurel Hill Cemetery could not show how funds received from the association were expended. Since the association could not show how funds were expended it was determined that it was not being operated with a profit motive and as such was not entitled to Section 162 deductions.

The court distinguished this case from the findings in Graceland Cemetery Improvement Fund v. U.S., 75-1 USTC P9400.

Leonard Ruck, Inc. v. Comm., TC Memo 1969-16, CCH 29.426

Compensation paid to family members who were the officers and shareholders of the corporation, was determined to be excessive based on personal services rendered by each.

Lodging was separately furnished to two shareholders (mother and son) adjacent to the funeral home. Fair rental value was disallowed and was added to their gross income. Court ruled that these shareholders were not required to live in their respective homes and that the homes were furnished for their own convenience and not the corporation's.

Meadowlawn Memorial Gardens, Inc. v. U.S. 46 AFTR2d 80-1362, US Court of Claims, No. 535-77, Aug. 13, 1980, Jears 1972-1973, Decision for Gov't

Corporation is a taxable cemetery corporation formed to provide a perpetual care cemetery in the state of Florida. The Cemetery Act of Florida provided that ten percent of the sale of cemetery properties was to be set aside in a trust fund, which the corporation did. Early on, the corporation made a policy decision to build the trust fund faster by reinvesting the trust earnings back into the trust fund and making additional year-end, lump-sum contributions.

The court held that reinvested earnings should be included in income and no deduction is allowed to Meadowlawn for the lump-sum contributions in excess of the statutory ten percent. Corporation is not contractually or legally obligated to contribute more than the amounts required by the State, the additional sums contributed were more in the nature of a reserve which is not deductible and since the sums were not decided until the end of the year it was not "impressed" with a trust when received.

Mercantile Bank and Trust Company as Trustee of the Troost Avenue Cemetery Company and Abbey Fund Trust, Appellant v. U.S., Appellee, and commerce Trust Company, as Trustee of the Troost Avenue Cemetery Chapel Gardens Mausoleum Trust, Appellant v. U.S., Appelle 71-1 USTC P9325, Affirms D.C. 70-1 USTC P9450

Troost Avenue Cemetery Company formed the above trusts (Abbey and Chapel) as follows. The banks noted above are the respective trustees.

1) It agreed with the purchaser of mausoleum space to fund five percent and ten percent of the sales price into the respective trusts, the corpus to be committed irrevocably and exclusively for the perpetual care and maintenance of the mausoleum.

2) The trust income was to be used exclusively for the care and maintenance of the mausoleums.

3) The trusts were operated separately from the cemetery company and each other.

4) The income from the trusts was paid to the cemetery company for the maintenance of the mausoleums.

5) The income paid was inadequate for the care and maintenance and the cemetery made up the difference.

6) The cemetery and mausoleums were formed under the Missouri "Endowment Care Fund Law." All contracts and laws regarding were adhered to.

The court found the trusts to be taxable trusts not qualified under Section 501(c)(13) of the Internal Revenue Code for the following reasons:

The trusts did not establish that they are a cemetery within the meaning of the term as used in Section 501(c)(13) of the IRC in that the trusts only provided funds for care and maintenance. The court outlines the functions of a cemetery and compares this to the trusts.

The court agrees with the findings in:

a) Rosehills Cemetery Co. v. U.S., N.D. Ill., (68-1 USTC P9309)

b) Evergreen Cemetery Assoc. v. U.S., W.D. Wash., (70-1 USTC P9127)

The court <u>did not agree</u> with the findings in:

a) Denver United States Bank v. U.S., 65-2 USTC P9556

b) Washington Trust Bank v. United States, E.D. Wash., (69-2 USTC P9568)

The court further found that Revenue Ruling 58-190, C.B. 1958-1,15 which allowed tax exempt status to similar trusts applied only to non-profit cemeteries. Revenue Ruling 64-217,C.B. 1964-2, 153 was applicable to trust operating in conjunction with for-profit cemeteries. It concludes that the tax status of the cemetery controls the tax status of the trust.

Milich 40 TA 282 (May 1988)

Covenants not to compete likely to be looked at even more closely by Service.

Montrose Cemetery Co. v. Com. 39-2 USTC page 619

The case determined the proper gain to be reported on the sale of cemetery land in 1931, which was acquired prior to March 1, 1913. A basis in the land, as of March 1, 1913, was also determined.

Mount Vernon Gardens v. Commissioner, 34 TC 598 Dec. 24.254

The two key issues were:

1) Whether or not amounts set aside in a building trust fund by a cemetery corporation out of the purchase price of burial lots (15 percent or more of the purchase price) were taxable income to the corporation. YES!

2) Whether or not the average cost of developing and improving each cemetery lot sold was included in the cost basis of each lot sold, even though the improvements had not been contracted for or made.

Taxpayer was a for-profit cemetery corporation. The taxpayer created the Perpetual Care Fund (PCF) and the Development Trust Fund (DTF). They required $15 per burial space or the amount required by law, whichever was greater, to be put into the PCF. They required 15 percent of each burial sale to be put into the DTF.

The landscape architect gave a detailed estimate of the cost for the complete development of the cemetery. The minimum cost was $2.7M and the maximum cost was $3.9M. The architect estimated an average development cost of $16.03 per burial space.

Taxpayer contends that the portion of the sales price of lot sales allocable to the Development Trust Fund was not properly a part of their gross income. They claim that if these amounts are to be included in income then the same amounts allocable to the DTF in a certain year must be included in the cost of the property sold that year or in any event there should be included in the cost of each burial lot its allocable portion of the ACTUAL and ESTIMATED COSTS for development.

The Government concluded that the amounts set aside for the Development Trust Fund are to be included in income. The government also concluded that the amounts allocable to the Development Trust Fund should be added to the cost basis of the lots being sold even though such improvements have not yet been contracted. In so far as the t/p is concerned, these funds have been impressed with an irrevocable trust to use for such improvements and will never revert to the t/p.

Cases:

1. Mount Vernon Gardens Inc. v. Com. 34 T.C. 598 was reversed in part by the United States Court of appeals in 1962 (298 F.2d 712) pertaining to the estimated development cost to be included in the lot basis.

2. Memphis Memorial Park v. Com. 84 F.2d 1008.

3. National Memorial Park v. Com. 44-2 USTC 9542.

4. Gracelawn Memorial Park v. U.S. 58-2 9897.

5. Com. v. Cedar Park Cemetery Assoc. 50-2 USTC 9376.

6. Com. v. Laguna Land & Water Co. 41-1 USTC 9302 Nye, 50 TC 203 (1968).

No allocation was permitted to the covenant since the corporation received nothing from it (covenant agreement between affiliated entities).

Oak Woods Cemetery Ass'n. v. Commissioner, 40-1 USTC p. 475

The key issue is the valuation of cemetery lots which were sold after March 1, 1913 and the controversy here is concerning the proper value of the unadjusted basis to be used in determining the recognized gain in the respective years in which the lots were sold. The law states that the basis to be used in the determination of gain or loss from the sale of property acquired before March 1, 1913 shall be the cost of the property or the FMV at that date, whichever is greater.

The Board states that it clearly considered all the evidence before it in fixing the March 1, 1913 value of cemetery lots and as such its findings are supported by substantial evidence.

Counsel for Oak Woods contend that all of the substantial evidence supports a much greater value than that found by the Board and that the Board applied an incorrect rule of law to the evidentiary facts found. They recommended the retail method in determining the FMV of the cemetery.

The taxpayers computed their gain by using values on March 1, 1913 of $1.50, $1.60, and $2 per square foot. The Commissioner of IRS fixed the value at 23 cents per square foot. The Board of Tax Appeals determined the value at 42 cents per square foot.

Cases:

1. Fairmont Cemetery Assoc. v. Helvering 35-2 USTC par. 9482.

2. West View Cemetery Assoc. v. Com. 38-1 USTC par. 9221.

3. Elmhurst Cemetery Co. v. Comm. 300 37-1 USTC par. 9084.

4. Montrose Cemetery Co. v. Com. 39-2 USTC par. 9570.

Prichard Funeral Home, Inc. v. Com., 21 TCM, 1399, T.C. Memo 1962-259

Company received payments for prepaid funeral arrangements. No contractual restrictions were placed by the payors on the use and disposal of the funds and how the funds were to be held. Payments received for pre-need arrangements were either deposited into a savings account established for the pre-need funds or the company's checking account. Interest earned on the saving account was withdrawn by taxpayer.

Court ruled that prepaid income received for future funeral services is taxable in the year of receipt because amounts received were not subject to any limitation as to the use or enjoyment by the company and payors did not request or require that amounts be segregated in a separate bank account or in any way.

Prichard Funeral Home, Inc. v. Com., T.C. Memo 1966-276 Dec. 28.222

Same issue as above in the subsequent year. Payments received for future funeral services to be rendered and not placed in trust determined to be income in the year of receipt.

Provident Nation Bank, (DC) 71-1 USTC P9345

The case involves a private trust formed to provide the funds for the perpetual care and maintenance of a family mausoleum. The income from the trust was to first provide for the care and maintenance of the particular mausoleum and then was available for the general care and maintenance of the cemetery. The trust was attempting to establish that it was either 1) Exempt from tax as a cemetery company 2) That the distributions to the cemetery company qualified as distributions to its beneficiary.

The court rejected both arguments stating that the trust did not qualify as a cemetery company in that obviously the trust was set up to benefit the family mausoleum and not for the general care and maintenance of the cemetery. Even if the funds were to be spent on the cemetery in general it was only to benefit the testator. The court also determined that the cemetery was not a beneficiary of the trust but only an organization which the trust engaged to furnish services of maintenance and care. The trust was neither allowed tax exempt status nor deduction for the amounts conveyed to the cemetery.

Puritan Lawn Memorial Park Cemetery, Cls Ct. 88-2 USTC P9438

Puritan is a tax exempt cemetery corporation which provided burial services. Endicott Associates is a taxable corporation whose principal functions included the leasing of certain property to Puritan, selling bronze markers, and acting as Puritan's agent for the purpose of selling burial lots and crypts. The sole shareholder and organizer of Endicott is the organizer of Puritan.

An agreement was executed between Puritan and Endicott whereby property called "The Pierce Land" was conveyed and deeded by Endicott to Puritan. The agreement called for Endicott to subdivide and develop "The Pierce Land" for Puritan, for burial purposes. Endicott was reimbursed for the development costs solely out of sales commissions received from Puritan which was 75 percent of the total receipts from its sales for Puritan. The same agreement allowed Puritan the use of an adjoining property called "The Acres" for free, for 40 years, after which "The Acres" will be conveyed to Puritan free and clear of mortgages. The court revoked Puritan's exempt status because the transfer of "Pierce Land" was not an arm's length sale. Missing were the elements of debt, such as:

a) Unqualified obligation on Endicott to pay because the installments depended on the sale of grave sites.
b) Maturity date.
c) A sum certain.
d) A stated interest rate.
e) A minimum annual payment.
f) A right to share in the assets.
g) Paid-in capitalization of the business.
h) Control over operations.

The court determined that no debt existed but only an equity interest was created. An equity interest in a cemetery company is considered an interest in the net earnings of the cemetery resulting in inurement and disqualification.

Court cases cited:

> Rose Hills Memorial Pk. Ass'n v. U.S., 199 Ct.Cl. 6, 463 F.2d 425 (1972).
>
> Restland Memorial Park of Dallas v. U.S., 509 F.2d 187 (35 AFTR2d 75-978).
>
> Knollwood Memorial Gardens v. Commissioner 46 T.C. 764 (1966) Rev. Rul. 77-70, 1977-1 C.B. pg. 150.

Contrary to the agreement signed, Puritan was charged rent for "The Acres" and property was not transferred to Puritan at the end of 40 years. The court found that disregard of the contract terms was inurement of benefit to Endicott.

Court cases cited:

> John Marshall Law School v. U.S., 81-2 USTC para. 9514, Ct. Cl. 6/81.
>
> Founding Church of Scientology v. U.S., 188 Ct. Cl. 490, 412 F.2d 1197.

Resthaven Memorial Park and Cemetery Association, (DC) 57-2 USTC P9857, 155 F. Supp 539

A non-profit corporation organized to care for and maintain a burial ground was found to be tax exempt under Section 101(5) of the 1939 Code even though it derived some income by means of outside investments.

Restland Memorial Park of Dallas v. U.S., 75-1 USTC P9308, 509 F.2d 187, affg 371 F. Supp 164

Cemetery company was denied on appeal a tax exempt status. The Appeals court agreed with the District Court that the dealings of the company with its officer/shareholders constituted inurement of benefits to private individuals. The land of a taxable cemetery company had been transferred to a new corporation owned and operated by the same individual but which had applied to be a tax exempt organization under Section 501(c)(13) of the IRC.

The courts found that there was no actual debt created by the transfer of the assets to the new corporation since the elements of a valid debt did not appear to exist. The transfer of the land was deemed to be an equity interest in the corporation and therefore payments to the original owner of the land were deemed to be distributions of equity which was enough to deny the tax exempt status.

Rose Hills Cemetery Company as Trustee of the Rosehill Cemetery Endowed Care Trust and of the Rosehill Cemetery Mausoleum Endowed Care Trust v. U.S. 68-1 USTC P9309, 2185 F. Supp 21, D.C.

Two non-profit trusts were found to be non exempt from tax under Section 501(c)(13) of the IRC. The trusts did not qualify as cemetery companies. Since the income was furnished to the for-profit cemetery which had formed them, it was determined that the shareholders of the cemetery indirectly benefited, even though the funds were used for the perpetual care and maintenance of the cemetery. The trusts were determined to have the same tax status as the organization that they benefited.

Rose Hills Memorial Park, Inc. (Connecticut) v. Comm 23 TCM 1434, Dec. 26.961(M), TC Memo 1964-240

Cemetery corporation was allowed tax exempt status notwithstanding certain transactions between the cemetery corporation and a related company.

Rose Hills Memorial Park Inc. was formed as a non-stock corporation to own, operate and manage one or more cemeteries or memorial parks. Rose Hills Cemetery Company conveyed to Memorial Park real estate which it previously had operated as a cemetery. The purchase agreement called for the following:

1) Purchase price was to be $112,500.00, which was 30 percent of the then retail price and fair market value of $375,000.00 of the 3,021 unsold graves contained in the real estate.

2) The price was to be paid in not more than eight installments of not less than $10,000.00 nor more than $17,500.00 beginning 12/31/56.

3) The unpaid balance was to bear interest of three percent per annum after January 1, 1960.

By contract Memorial Park granted Cemetery exclusive rights as its "Selling Representative" for all its cemetery lots for a term of ten years. Cemetery was to receive 45 percent of the sales price of each cemetery lot to be paid upon receipt of a lump sum or out of the first payments made under deferred payment account. The 45 percent commission was in accordance with the practice prevailing in the cemetery industry. Memorial Park had the option of terminating the commission agreement with Cemetery if sales failed to meet designated amounts.

The court allowed the Memorial Park tax exempt status with the following reasoning:

1) The purchase price paid by Memorial Park was fixed and not dependent upon the proceeds realized from the sale of individual lots.

2) The court felt that since Memorial had to pay Cemetery in not more than eight annual installments with no interest for four years and three percent interest on the balance that there was no unreasonable price or extended credit.

3) Since the commissions paid to Cemetery were in line with industry practices, the court did not feel that these amounts were distributions of earnings on an equity basis.

Rose Hills Memorial Park Association v. U.S. (Ct Cls.) 72-2 USTC P9554, 463 F.2d 425, cert den 414 US 822, 38 L Ed 2d 55

A cemetery was found by the court to be not exempt from Federal Income Tax since some of its earnings inured to the benefit of private individuals.

Rose Hills Memorial Park Association was incorporated as a non-profit cemetery corporation. It purchased the stock of a for-profit cemetery corporation (Bartolo Corporation). The trustees of Rose Hills were the shareholders of Bartolo Corporation. The consideration to be paid for the stock was as follows:

1) 30 percent of the gross selling price of gravesites sold from any property acquired from Bartolo.

2) Ten percent of sales of mausoleums, niches, and crypts.

3) 20 and 25 percent of sales of various underground crypts.

4) 50 percent of rents and royalties received for the use of any of plaintiffs real property.

5) 90 percent of the sales proceeds, during the first five years; 80 percent of the sales proceeds, during the following ten years; 75 percent of the sales proceeds for years thereafter of sale of real property under any other circumstances.

The court determined the agreement to sell the stock was actually an equity investment by Bartolo in Rose Hills Memorial Park Assn and therefore Rose Hills did not qualify to be a tax exempt organization since economic benefit inured to private shareholders or individuals.

The traditional elements of a valid debt were found missing from the transaction, those elements being:

a) There was no unqualified obligation on plaintiff to pay because the installments depended on the sale of gravesites.

b) There was no maturity date because the obligation was to continue until all lots were sold.

c) There was no sum certain because the market price of gravesites could change.

d) There was no stated interest rate.

e) There was no minimum annual payment.

f) There was no right to share with general creditors in the assets because subsequent to the agreement the former Bartolo shareholders exercised their discretion to subordinate their claim to other debts.

g) There was no paid in capitalization to the business.

The court added that while it did not mean by its decision to hold that the percentage of sales agreement is, per se, a violation of Section 501(c)(13), it did feel that the Kensico and Forest Lawn cases have been considerably weakened by subsequent cases.

Schulz 294 F.2d 52, 61-2 USTC P9648, 8 AFTR 2d 5406 (CA-9, 1961)

If there are countervailing factors between the parties as to allocation to the covenant, the Service is not likely to interfere.

Sherwood Memorial Gardens, Inc. (Tennessee), Petitioner v. Commissioner of Internal Revenue, Respondent, 65-2 USTC P9537, affirms 42 TC 211

Issue 1

Thin Corporation - payments made by the taxpayer, a for-profit cemetery corporation with a debt-to-equity ratio of 60 to one, on Certificates of Indebtedness which it had issued in exchange for the transfer to it of land and cash, were nondeductible distributions with respect to the equity investment. Such payments were not deductible as the cost of land sold.

<u>Issue 2</u>

Development Costs - The accrual basis taxpayer set aside in separate bank account 15 percent of the proceeds from the sale of burial plots as a fund for the development and improvement of the cemetery. It was held that the taxpayer was the primary beneficiary of the fund and that amounts could not be excluded from income. The taxpayer could only deduct its actual development costs and they had to be allocated to the cemetery as a whole and not to each garden developed.

<u>Utter-McKinley Mortuaries, Inc. v. Comm. 12 TCM 814, US Ct. of Appeals 9th Cir. aff'g</u>

Corporation, who owned, leased and operated various mortuaries negotiated for the lease of another mortuary. Lessor refused to deal with a corporation, so the 75 percent shareholder/president purchased the mortuary business and leased the property. Shareholder sold business to taxpayer for same amount and subleased property to taxpayer at a rate in excess of what he was paying the lessor. Court determined that rent paid by Utter-McKinley was not reasonable and was not deductible to the extent it exceeded terms of original lease. Shareholder should not profit personally in a transaction intended to benefit corporation.

<u>Washington Park Cemetery Association Inc. 22 TCM 1345, Dec. 26.336(M). TC Memo, 1963-268</u>

Cemetery company was found to be tax exempt for federal tax purposes.

Washington Park Cemetery Association Inc. was a corporation formed to acquire the assets of Indiana Cemetery Corporation (a for-profit corporation).

The assets of Indiana Cemetery were originally purchased by a syndicate of thee individuals who were also the incorporators of Washington Park Cemetery. The syndicate, soon after the purchase of the assets from Indiana, sold the same to Washington Park at a substantial increase in value. The syndicate was to be paid by Washington Park issuing non-negotiable, non-interest-bearing, unsecured debentures with a maturity date of at least 35 years.

Washington Park was required to set aside at least ten percent of the retail selling price of grave space, crypt space, niche space, monument, marker or other item sold at retail to the public to provide for payment of the debentures. The government contended that the purchase price by Washington was so overstated that, in effect, it was a payment of Washington Park's future anticipated earnings and therefore, it contended that a portion of the net earnings would inure to the benefit of the members of the syndicate.

The court determined that the payment of principal and interest due on indebtedness incurred to acquire property are properly charges against gross income in arriving at net earnings. The court discounted the price paid by Washington Park to the syndicate and concluded the price was reasonable and that it did not constitute the inurement of net earnings to the benefit of the syndicate.

The court makes many references to Commissioner v. Kensico Cemetery 38-1 USTC P9283, 96 F.2d 594, affirming [Dec 9583] 35 BTA 498.

Note: Subsequent decisions have not followed the reasoning in this case and have found arrangements such as these to inure benefit to the owners.

<u>Washington Trust Bank, as Trustee of the Endowment Care Fund of Greenwood Memorial Terrace Company v. U.S. 69-2 USTC P9568</u>

Case involves a claim for refund from the Endowment Care Trust. The trust originally filed its return as a taxable entity. The trust did the following:

1) Received ten percent of the sales price of the burial sites and mausoleum spaces sold by Greenwood Cemetery Corporation. Payments received were in accordance with Washington state law.

2) Separate bank accounts were kept for the trust funds.

3) The trust disbursed its income back to Greenwood Corporation where it was commingled with other Greenwood Corporation Funds.

4) Amounts paid to care and maintain the cemetery by Greenwood Corporation far exceeded the trust income turned over to Greenwood Corporation by the trust.

5) Greenwood Corporation made no charge against the trust income for its overhead or other management or capital outlays.

The court found that:

1) The trust was tax exempt cemetery under Section 501(c)(13) with the following reasoning:

    a) The trust paid all its income less management expenses to the cemetery corporation.

    b) The trust, under provisions of the Washington state law and the trust provisions were to "forever remain irreducible and inviolable for the perpetual care of the cemetery" and no amount was to adhere to the benefit of the shareholders of Greenwood Corporation.

    c) Greenwood Corporation was not a beneficiary of the trust. The true beneficiary of the trust were the purchasers of the burial lots, mausoleum spaces and the general public.

d) The trust income was used solely to care and maintain the cemetery and not for any overhead expenses of Greenwood Corporation.

<u>West Laurel Hill Cemetery Co. v. McLaughlin, 44 F. Supp 63</u>

A cemetery company acquired land from its shareholders and from unrelated parties as the need arose. The cemetery set aside ten percent of the sales price of lots in an endowment care fund for the perpetual care of the cemetery. The company made distributions to the shareholders from the funds remaining.

The court found that the cemetery did not qualify as a tax exempt organization under Secs. 103(5) of the 1932 Act and Secs. 101(5) of the 1934 Act.

Section 9

GLOSSARY

Adversary Memorial Society	-	A nonprofit, consumer oriented organization that advocates and disseminates information about low-cost simplified alternatives to traditional funeral practices.
Agreement Memorial	-	A nonprofit organization charging an initial Society membership fee for contracting with a local mortician to provide a limited range of low-cost funeral services at time of need.
Beneficiary	-	The person for whom the funeral services are arranged.
Burial Park	-	A tract of land for the burial of human remains in the ground, used or intended to be used, and dedicated for cemetery purposes.
Burial Permit	-	A legal document authorizing the disposition of individual human remains. It is usually obtained by the mortuary and given to the cemetery. In California it is used by the county health department except for Pasadena and Long Beach which require the city health department to issue. It is filed in the city/county of burial/ disposition. It must be obtained prior to the disposal of human remains.
Burial Vault	-	An outer burial container generally constructed of concrete or metal designed to provide additional protection to a casket or to inhibit the sinking of soil above a grave.
Cash Advance	-	Goods or services paid for by the funeral provider on customer's behalf. Cash advance items include flowers, obituary notices, pallbearers, and clergy honoraria. Some funeral providers charge you their cost for these items and some add a service fee to their cost.
Casket	-	A rigid rectangular receptacle designed to hold human remains, usually made of wood or metal and often decorated and lined with fabric.

Cemetery - Means any one, or a combination of two or more of the following:

a) A burial park, for earth interments.
b) A mausoleum, for crypt or vault interments.
c) A crematory, or a crematory and columbarium for cinerary interments.

Cemetery Authority - Includes cemetery association, corporation sole, or other person owning or controlling cemetery lands or property.

Cemetery Corporation/
Cemetery Association - Any corporation now or hereafter organized which is or may be authorized by its articles to conduct any one or more or all of the businesses of a cemetery, but do not mean or include a corporation sole.

Cemetery Board - In California it is a board consisting of 6 members and is appointed by the Governor. It is set up by the State Department of Consumer Affairs, which is part of the State Consumer & Services Agency. The board is one of many established to ensure that those in private business and professions deemed to have an impact on public health, safety and welfare are adequately regulated to protect the people of California.

The board has the power to:

1) Establish minimum qualifications and levels of competency.

2) License, register or certify persons in the professions.

3) Set minimum professional standards and insure compliance.

4) Investigate allegations of unprofessional conduct, incompetence, fraudulent action or unlawful activity.

5) Institute disciplinary action where warranted.

	6) Conduct periodic checks of otherwise certified persons in order to ensure compliance with the relevant code sections.
Cemetery Broker	- A person who, other than in reference to an occasional sale, sells or offers for sale, buys, or offers to buy, lists, leases or offers to lease, or solicits, or negotiates the purchase or sale, lease or exchange of cemetery property or interment services, or interest therein, for his or her own account or for another. Bus. & Professions Code Chapter 19 Article 1.
Cemetery Salesman	- Is a natural person who, other than in reference to an occasional sale, is employed by a cemetery broker to sell or offer for sale, list or offer to list, or to buy or to offer to buy or to lease or to offer to lease or to solicit, or to negotiate the purchase or sale or lease or exchange of cemetery property or interment services or any interest therein for his or her own account or for another. Bus. & Professions Code Chapter 19 Article 1.
Certificate of Authority	- The license by the State Cemetery Board to operate a cemetery.
Columbarium	- Building used for the interment of cremated remains.
Corpus of the Trust	- Principal moneys paid and securities delivered to establish the trust pursuant to provisions thereof.
Cooperative Mortuary	- A mortuary owned and operated by participating community members for the benefit of cooperating members.
Cremation	- Reduction of human remains to ashes by incineration. Ashes are normally placed in an urn, which can be subjected to various methods of disposition, above ground or below. Direct cremation refers to the practice of cremating the body without prior viewing or visitation.
Crematory	- An establishment that performs cremation. The furnace for cremating human remains. Synonym: Crematorium.

Crypt	-	A burial vault either in a mausoleum or underground. Below ground crypts are also called lawn crypts.
Death Certificate	-	A legal document attesting to the date, time and cause of death and signed by a physician, coroner, or medical examiner. The death certificate in California is obtained by the mortuary and is filed with the county health department. (In Los Angeles County, the cities of Pasadena and Long Beach require the death certificate to be filed with their city health departments. All of the certificates are forwarded to the county recorders office.)
Direct Burial/ Immediate Burial	-	The immediate removal of the body by a funeral director and delivery of it to the cemetery in a simple container, without viewing, embalming, or cosmetic restoration of the body; generally followed by a memorial service in a home or chapel without the body present.
Embalm	-	To sanitize and preserve a deceased human body chemically to arrest putrefaction.
Endowment Trust Fund	-	Funds established for the perpetual care and maintenance of the cemetery. Fund comes from a charge added to sales either as a flat fee or a fixed percentage of the grave sale.
Funeral Director	-	An individual who manages funerals and other services associated with the disposition of human remains. Many funeral directors are embalmers. Synonyms; mortician or undertaker.
Funeral Home	-	A commercial establishment that handles preparations and arrangements for funerals and other ceremonies connected with the disposition of the dead (the term funeral home is most often used in the east and the term mortuary is most often used in the west).
Funeral Service	-	Any observance, service, or ceremony held for a deceased human body, usually before burial, cremation, or other final disposition.
Grave Liner	-	See burial vault.

Grave Marker	-	An upright monument of some sort (in a cemetery) or a bronze plaque laid in the ground (in a memorial park).
Inurement	-	Placing cremated remains in an urn and placing it in a niche.
Interment plot	-	Means space in a cemetery used for the interment of human remains. Also known as "lot" or "plot."
Mausoleum	-	A building housing crypts, which is owned privately and intended for use by a single family or is owned by a community and large enough to hold many crypts and is meant for the interment of uncremated human remains.
Memorial Service	-	An elegant ceremony that can take place in a home, church, funeral home, usually in the absence of the body. Frequently a memorial service is held in a private home after direct burial or immediate cremation has taken place.
Monument	-	An inscribed grave marker, usually made of stone.
Niche	-	A space in a columbarium for inurement of cremated remains.
Obituary	-	A printed notice of an individual's death, commonly including biographical notes.
Outer Burial Container	-	Any container designed to be placed in the grave around a casket such as grave liners, boxes and burial vaults. Current practice is to make them of concrete.
Pallbearer	-	An individual who helps carry or escort a coffin during a funeral service.
Perpetual care	-	An arrangement made with a cemetery or memorial park to maintain a grave over a certain period of time, generally for as long as the cemetery exists.
Pre-need Plan (Prearrangement)	-	An arrangement made in advance for disposition of one's remains, usually pre-financed. The plan can cover the funeral service and/or the grave site.

		Article 9, Section 7735 - 7741 (page 18) Article 8, Section 1261 (page 37) of the Funeral Directors & Embalmers regulations.
Public Cemetery	-	Cemetery owned by and operated by city, county, public cemetery district (per West's Annotated Calif. Code).
Survivor	-	Person (usually relative) who has acquired the right to control the disposition of the remains.
Trustee	-	Any banking institution or trust company legally authorized and empowered by the State of California to oversee and manage trust funds. It could also be a group comprised of at least three persons one of whom may be an employee of the funeral director.
Trustor	-	Any person who pays the money or deposits the securities used for such pre-need arrangement.
Vault Liner	-	See Burial Vault.