MSSP

Market Segment Specialization Program

Garment Contractors

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

Training 3147-105 (6/97)
TPDS No. 83127Q

This page intentionally left blank.

Garment Contractors

TABLE OF CONTENTS

Chapter 4, Accounting Records

Chapter 5, Employees

Chapter 6, Accumulation of Information Before Starting the Audit

Chapter 7, Interview

Chapter 8, Examining Income

Chapter 9, Examining Expenses

Chapter 10, Employment Taxes

Chapter 11, Penalties

Chapter 12, Collection and Whipsaw Issue Considerations

INTRODUCTION

The original Garment Contractors examination information package was printed in March 1989 (for IRS use only), based on audits of approximately 25 different contractors. Subsequently, a revenue agent group specializing in garment industry examinations adopted that information package as a training tool and reference source. This current guide is a revision of the first which draws from the findings of that group's audits to expand upon, clarify, and update the original document.

During the 3 years, the specialization group used the original reference guide, examinations were conducted primarily on sewing contractors filing Forms 1040 and 1120. Most were Los Angeles District taxpayers.

This page intentionally left blank.

Chapter 1

SELECTION OF CONTRACTORS FOR AUDIT

<u>BACKGROUND</u>

*(<u>**Note**</u>: If this package is being used for a contractor return which has already been assigned to an examiner, the reader should skip this section and proceed to Chapter 2, General Background.)*

The garment specialty group did not rely on DIF selection and normal classification functions to identify contractor returns for audit. Instead, the process of identifying high potential contractor returns began with an expanded "package audit" during the examination of a garment manufacturer. In other words, as a manufacturer was audited, the examiner reviewed certain documents (such as canceled checks, invoices, Forms 1099) that pertained to contractors who performed services for the manufacturer. Those documents highlighted one or more contractors who were likely to have understated their income by significant amounts. By reviewing the canceled checks, the examiner had firm indications whether or not specific contractors were negotiating them in unusual ways, which by itself was a "red flag."

<u>STEP #1: REDUCE THE TOTAL NUMBER OF CONTRACTORS UNDER CONSIDERATION</u>

While completing the expanded "required filing check" step described above during the manufacturer's audit, the examiner should concentrate on those contractors with the highest dollar volume. Review of the Form 1099 is a good starting point. In addition, the disbursements journal should also be reviewed for other large volume contractors not included among the Forms 1099, since 1) the manufacturer may not have issued Forms 1099 to all who should have received them, and 2) Forms 1099 are not required to be issued to corporations, and contractors are sometimes organized as corporations.

<u>STEP #2: IDENTIFY DISBURSEMENTS TO THE SELECTED CONTRACTORS</u>

In preparation for reviewing the key documents (canceled checks), a representative number of disbursements made to the contractors selected in step #1 must be identified by check number, date, and amount. The manufacturer may already have the information available. For example, a schedule may have been prepared when the Forms 1099 were originally prepared, or the accounting system may automatically (either by computer or by manual record) list each payment made to each contractor, or a vendor file maintained for each contractor would include information to identify all disbursements made to the vendor of interest. Of course, the possibility exists that the examiner may have to schedule the checks that are to be inspected. This is the least convenient, from the examiner's point of view, but this step requires that checks for the selected contractors be identified, so that the examiner can inspect them.

STEP #3: INSPECT CANCELED CHECKS

The next step is to pull the checks for each selected contractor and to review the endorsements. The examiner will be looking for significant amounts of checks that were negotiated in unusual ways. For example, they may have been converted to cashiers checks, or cashed at the bank, or cashed at check cashing businesses, or deposited to a bank account located in another city or far from the contractor's place of business, or endorsed to another entity. Because contractors normally are closely held family businesses, with few accounting controls in place, failure to deposit normal business receipts in the contractor's business account may indicate that the income is not being reported for tax purposes.

STEP #4: SELECT CONTRACTOR FOR AUDIT

By the completion of Step #3, the examiner will have identified one or more contractors whose audits he or she will spin-off. The examiner should request the payment detail for these contractors for the subsequent years as well. The manufacturer will likely not have any reservations about providing the requested information at this early stage of its own audit; it may be more difficult at the later stages.

STEP #5: SECURE DOCUMENTS FOR CONTRACTOR FILE

The information to be accumulated for each contractor that will be spun off should include:

1. Form 1099
2. Payment ledger or printout
3. Front and back of all checks
4. Form W-9
5. Initial application to provide service
6. Any identification information that the manufacturer may have on the contractor

-- Such as past and current addresses, telephone number, state registration certificates (see Chapter 6 for more information about the state registration certificates), names, and social security numbers of the owners.

These documents will be supplemented with additional information before the examiner contacts the contractor (see Chapter 6, Accumulation of Information Before Starting The Audit and Chapter 8, Examining Income), but at this point, the examiner has a good foundation for starting the contractor audit.

STEP #6: SECURING THE CONTRACTOR RETURN

Generally, the contractor's return may be secured from the appropriate Service Center using standards procedures for doing so. Consider the following example, however, which is a common situation:

Example 1

The manufacturer has supplied all of the checks for the contractor of interest, but the Form 1099 reflects the following:

XXXXX's Contracting Service
000 E. 8th Street,
Los Angeles, CA 00000

Is this a corporation or a partnership? If so, what is its year end? Could this be a sole proprietorship? If so, who is the owner? What is the owner's social security number?

IDRS research is a good starting point. For example, command code INOLE often provides the following information:

1. Current address
2. Filing requirements
3. Fiscal year month end
4. Cross reference SSN.

Further, transcripts and command codes, RTVUE, and BRTVU could provide valuable information to secure the tax return of the contractor.

If IDRS research is inconclusive, the examiner may have to research business license records, bank records, DMV records, the California garment industry registration directory, or similar sources to identify the correct and complete name of the taxpaying entity, perhaps to obtain the identifying number, and perhaps to determine its year-end.

Of the sources of information listed above, the only source of information that is peculiar to the garment industry is the California garment industry registration directory. (Local State's Department of Labor should be contacted to determine directory listings of garment industries.) This is a listing of all garment industry entities that have a current registration on file with California, as required by State law. This directory can be useful for finding a current address for a taxpayer and sometimes to identify an entity type. The garment specialty group in Los Angeles has current and past copies of this listing. A corporate entity doing business under its corporate name would have a listing as follows:

Registration No. 26-1111111 Expires 9/9/94
Contracting Company, Inc.
222 Main Street, #1010
Los Angeles, CA 90007

A sole proprietorship, partnership, or corporation doing business under a D.B.A. name would have a listing as follows:

Registration No. 26-2222222 Expires 8/8/94
Charles Jones
D.B.A.: Charlie's Creations
1111 Wilshire Blvd.
Los Angeles, CA 90015

There are no patterned search procedures for identifying the taxpayer (whether an individual, a partnership, or a corporation), its taxpayer identification number, and its year-end, all of which are necessary to requisition a return. The specific steps that must be taken will be determined by how much and what kind of information is initially available to the examiner. When this Market Segment Specialization Program was being developed, all of the sources mentioned above (and several others) were used at one time or another. An examiner with little experience in finding a taxpayer and its identification number should draw on the following sources for guidance: A more experienced agent, a group manager, a fraud group agent, a revenue officer. All of these individuals should have some experience working with the more common of the sources mentioned. See Chapter 6 for further discussion of information sources.

An alternate way of selecting contractors that will be examined: Instead of concentrating on high volume contractors, as described in Step #1 above, some examiners went directly to a sampling of canceled checks as part of the cash audit. This sequence started with 1 to 3 months of the manufacturer's canceled checks; the examiner inspected the backs of all checks in this sample period for indications of check cashing. From the list of follow-up candidates generated in this step, the examiner went into Steps #4, 5, and 6. There are advantages and disadvantages with both sequences. The selection of which method to follow rests with the individual examiner. However, the alternative method is best used by those who have extensive experience examining garment contractors.

SUMMARY

What has the examiner learned about the contractor selected for audit, other than income may be underreported? The checks secured from this one manufacturer will also tell the examiner:

1. One or more banks where a contractor has an account.

2. One or more of the bank accounts where the contractor deposits receipts.

3. Who actually negotiates the checks, if not the principal (A relative? Spouse? A third party?).

4. The approximate percent of total receipts from this manufacturer that are deposited.

5. How and where checks not deposited in the contractor's business account are negotiated.

6. Perhaps an address or a driver's license number that may be useful when trying to identify and locate a contractor, as discussed above in Step #6.

This knowledge is extremely useful for designing initial interview questions to verify information gained from the contractor. Keep in mind that the examiner will have accumulated information from other sources before meeting with the contractor. The background available to the examiner should allow the examiner to hold a very effective interview (instead of asking standard, "canned" questions), one which will provide valuable information for developing any potential income issue, as well as any others the examiner may want to raise.

<u>A word of caution.</u> Unusual negotiation of checks does not "guarantee" that the examiner will eventually find an income understatement. For example, contractors have been known to report their income based on Forms 1099 they receive; in this case, a sole proprietor could conceivably be cashing a substantial portion of receipts, while reporting the correct amount of income.   It is conceivable, but it is not probable because if a contractor is reporting based on Forms 1099 received, he or she will

probably have performed services for manufacturers who did not issue a Form 1099 to the contractor.

<u>A second word of caution.</u> A basic premise of the procedure described above was that there would be follow-up on selected contractors only if the canceled check inspection demonstrated that the contractor was negotiating checks in an unusual manner. It should be obvious, that even if a contractor deposited all checks from the particular manufacturer, there are no assurances that the income was reported for income tax purposes. As a matter of fact, in one case, the contractor's checks all seemed to have been deposited, with no unusual negotiation of checks. The endorsements reflected that deposits were made to one of two accounts, both at the same bank. The examiner was not too concerned, because contractors frequently have a general bank account and a payroll bank account, both of which receive deposits of checks representing gross receipts. When income was examined, however, it was found that only the deposits to one account were included in gross receipts. The other account was a personal account, in the owner's name, and it was never presented to the preparer when the return was prepared.

All procedural suggestions in this information package were used and tested prior to inclusion in this narrative; the process of generating contractor audits from that of a manufacturer exam was an extremely successful one, and resulted in substantial adjustments.

Chapter 2

GENERAL BACKGROUND

INDUSTRY OPERATIONS

The garment industry is a complex and related array of businesses and organizations all directed toward the goal of producing the garments which will satisfy the current fashion needs of consumers. Within the industry, there are various levels through which raw materials are transformed into fabric and trim, which in turn are transformed into a garment.

The first level, and the one with which people are most familiar, is the retail store. The second level is the manufacturing level which designs the garment, secures fabric and materials, coordinates all aspects of the construction of the garment, and sells the finished garments to retailers. Some manufacturers cut, sew, and perform all operations needed to assemble a particular garment. However, major phases of the manufacturing process are normally "contracted out."

Along this same second level lies the manufacturers and converters of fabric. These entities convert raw materials into the fabrics which are used by the garment manufacturers.

The third level is where a garment is normally constructed and assembled. These entities, which are responsible for the construction, are known as contractors and sub-contractors and are the focus of the following audit procedures and techniques. Contractors can be classified by the function they perform in the assembly of the product. These functions can be classified into several primary areas: cutting, sewing, and specialized services. These contractors are supervised by the manufacturer, in the sense that the latter provides most materials, sets the specifications to be followed, and inspects work in process and finished garments to ensure the process was completed properly.

CONTRACTOR SERVICES

Contractor services include cutting, sewing, and other specialized contractors are discussed below.

Cutting

Before the construction can begin, the material or fabric must be cut into the various patterns and sizes which will make up the particular garment. This is the basic responsibility of the cutter. He or she will receive the bolts of fabric from the manufacturer and cut it to the manufacturer's specifications. These specifications are mapped out on a pattern known as a "marker." These markers are provided by the manufacturer.

Sewing

The sewing contractor will receive the bundled cut fabric from the manufacturer or cutter and will be given the special instructions and a sample for the sewing. The manufacturer will usually supply all needed materials such as fabric, trim, buttons, labels, plastic bags, and hangers. The only supplies the sewing contractor usually provides is the thread, needles, and knives. Therefore, the ending inventory is usually very minimal.

Consistent availability of work for a contractor generally depends upon the seasonal fluctuations of the manufacturer's business. A contractor often attempts to work for several different manufacturers at one time. On the reverse side, a manufacturer will often employ numerous contractors at one time.

Other Specialized Contractors

There are other contractors which operate specialized services. At this point, there have been no audits of these specialties but some of the audit techniques would still apply.

Fusing

This service encompasses the bonding of the interfacing of a garment through a heating process to allow the particular garment sections (collars, cuffs, etc.) to retain their shapes.

Dyeing/Fabric Treatment

This specialty applies special coloring techniques to clothing or fabrics such as stonewashed or acid-washed jeans and garment dyeing.

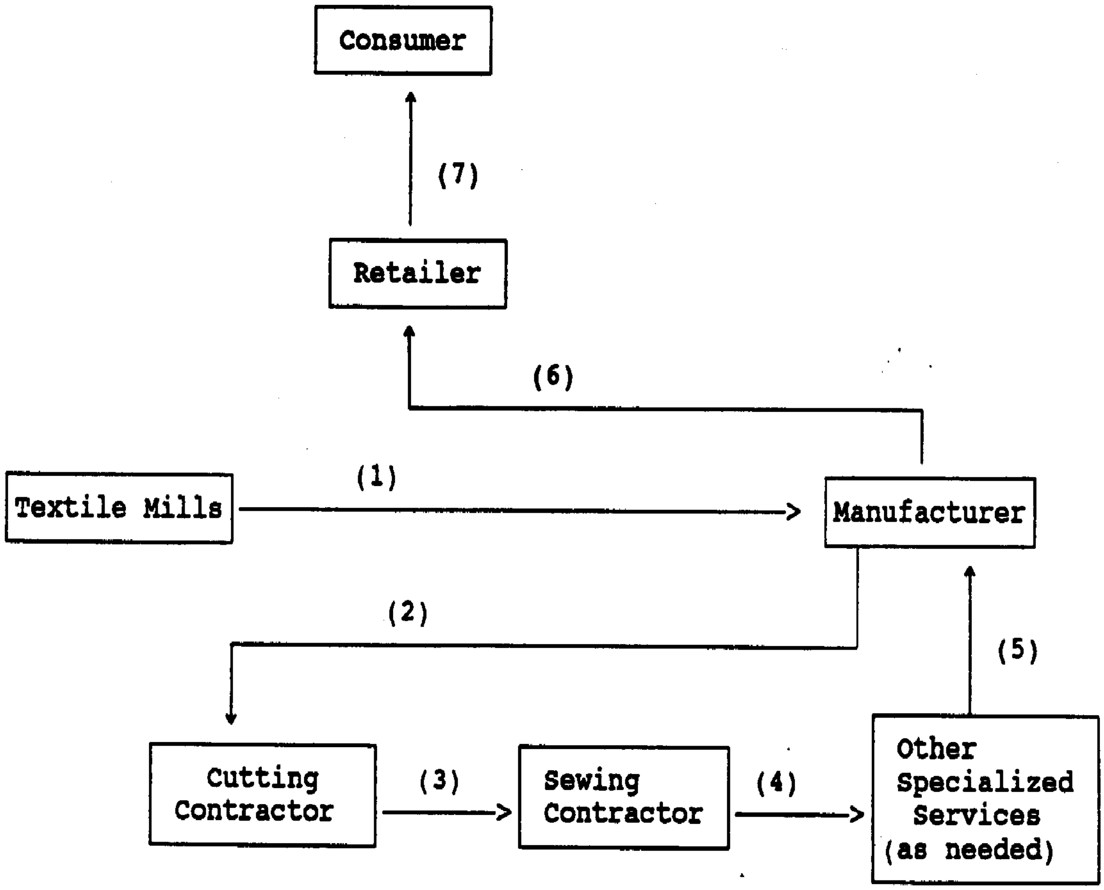
Pleating, Embroidery, and Other Specialized Operations

These services require the use of special equipment and skills. Although they may be offered in combination with other services, few conventional sewing or cutting contractors provides such services.

SUMMARY

The following chart summarizes this chapter.

Simplified Garment Industry Model



Industry Process
----

1. Manufacturer purchases fabric from textile mills.
2. Fabric cut by cutting contractor not by manufacturer.
3. Cut fabric is transferred to sewing contractor and is sewn into various garments.
4. Other specialized services, if needed.
5. Finished goods transferred back to manufacturer.
6. Goods are sold to retailers.
7. Goods are sold to consumers.

Chapter 3

CONTRACTOR'S RELATIONSHIP WITH MANUFACTURERS

BACKGROUND

The following paragraphs describe, in a general way, some of the more common aspects of the relationships between garment contractors and the manufacturers for whom they perform services. They should provide an examiner who has no previous experience with this type of taxpayer with an overview of the business relationship that a contractor has with its "customer."

The "Standards of Practice" (published by the Labor Commissioner of the State of California) illustrates guidelines that further define the contractor or manufacturer relationship.

OBTAINING WORK FROM MANUFACTURERS

Although local trade publications in some states often carry advertisements from contractors seeking work from manufacturers, the more common means of securing work is by building and maintaining a continuous working relationship with the manufacturers who regularly use a contractor. When initially evaluating the work of a contractor, a manufacturer will most often place a modest sized cut with the new contractor. If the work is satisfactory with regard to quality, price, and timeliness of completion, the contractor will likely receive larger amounts and more frequent work from the manufacturer. Usually, the "leverage" in the relationship rests with the manufacturer. In other words, contractors' services are not a scarce commodity; if a manufacturer becomes dissatisfied with the service he or she receives from a contractor, the manufacturer will not hesitate to cease doing business with the "problem" contractor.

EXCLUSIVITY OF WORKING RELATIONSHIPS

A contractor commonly receives the majority of its income from several manufacturers, while receiving significantly smaller amounts from a greater number of manufacturers. Exclusive contractor services performed for only one manufacturer is most often found where there is a high degree of common ownership between the two. A contractor does not want to be totally dependent on a single manufacturer; the contractor would be vulnerable to a cut off of work from the manufacturer. In addition, the contractor's workload, and hence its income, would be tied solely to the seasonal fluctuations of one manufacturer.

PRICE DETERMINATION

By the time a manufacturer is ready to have the first cut of a style placed with a contractor, the manufacturer has estimated the price that it is willing to pay to have the process completed for that particular style. There is room for some negotiation between the contractor and the manufacturer, but within a relatively small range. The negotiation for sewing, for example, may be over a price of $2.25 per unit versus $2.35 per unit, rather than whether the price should be $2.00 versus $3.50 per unit. For cutting, the range which the negotiations may cover might be an equally small amount. A number of factors are considered when the price is set: How complicated is the garment? How many pieces comprise each garment? How large is the cut? What type of material is being used? Is it a "rush job"? Will overtime be required? Is any special handling required? Is specialized equipment required? Must it be done by a contractor that does a specialized operation?

Sometimes, a contractor will request a price increase after he or she has started work on a cut. Unexpected problems of some sort are usually cited as the reasons for the need for the additional fee. In these instances too, the price change is a matter of cents per garment.

WRITTEN CONTRACTS

An absence of written contracts is common. If a contract exists, the manufacturer has required it. They are usually one page and contain "pro forma" terms applicable to all cuts they place with contractors. They generally contain the contractor's name and address, style and cut numbers, number of units, price, and date are the only variables. The examiner must specifically request the contracts from the contractor. The cutting ticket that transmits the goods to the contractor sometimes serves as the only written record of a business deal between a contractor and manufacturer. As with the contracts, the contractor may not have retained the cutting tickets. If these documents become important, the examiner has a better chance of securing them from the manufacturers. Although these documents are helpful, the use of canceled checks is often a more efficient and practical way to verify the contractor's income.

TRANSPORTATION OF GOODS

The contractor is usually responsible for transporting the cut goods to its shop, and the manufacturer usually bears the cost of moving the finished goods from the contractor. If one of the parties furnishes transportation in both directions, it bills the other for the additional expense incurred, unless the parties agreed to different arrangements.

PAYMENT POLICY OF MANUFACTURERS TO CONTRACTORS

The terms of payment are totally determined by the manufacturer. Some will pay when a portion of a cut is completed, recognizing that contractors have a continuing payroll cash drain, but others have a policy of only paying when a completed cut is returned. Likewise, some manufacturers will pay on the first designated day after the goods are received, while others will withhold payment (or a percentage of the payment) until the goods have been inspected. Each manufacturer has a designated day each week when it will issue checks for all work returned by contractors by the weekly cutoff day. Of course, there are exceptions.

Advances are the most common exception. A contractor may ask for advance payment of a portion of its fee for a particular cut, most often to meet payroll. Such requests can be made while a cut is in process, but there are some instances when a contractor gets an advance when it first receives a particular cut. These advances are made as a form of a short term, interest free loan; there are no written documents to evidence the advance, other than the check itself. Amounts advanced are subtracted from the amount otherwise due, when the cut is completed. Some manufacturers have a strict "no advance" policy. Others will make them to selected contractors on an "as needed" basis.

The examiner should determine the character of advances as either "income" or "loan." The period that the advances are outstanding is usually 1 to 2 weeks, and the total advances that any contractor has outstanding at the end of its tax year is usually a small amount. Advances are normally income since most contractors are cash basis taxpayers who are required to recognize the advances in income when received.

INVOICES ISSUED BY CONTRACTORS

When completed work is returned by the contractor to the manufacturer, it is accompanied by an invoice issued by the contractor. This is the means of billing the manufacturer for the services rendered. The invoices contain the style and cut numbers, the number of units, the per unit price, and the extension. Any miscellaneous charges made by the contractor are also included in this same invoice.

The examiner cannot depend on these invoice copies retained by the contractor as an auditing tool. They are frequently unnumbered, there are no accounting controls in place for most contractors, and they are often not made available by the contractors. In sum, the examiner has no means of determining if all invoices issued during a tax period have been provided by the taxpayer. If the examiner finds that contracts are absolutely necessary to verify the contractors income, the examiner is advised to secure them from the various manufacturers that paid the contractor during the year(s).

This page intentionally left blank.

Chapter 4

ACCOUNTING RECORDS

GENERAL INFORMATION

The accounting books and records of garment contractors can range from a shoe box full of receipts to a formal double entry set of books. Accordingly, be prepared to deal with a variety of different accounting systems. In addition, the examiner may also find that some records may be missing, and accounts do not balance. These problems may be due to a lack of internal control for books and record keeping.

Generally, contractors will record income from monthly total bank deposits, Forms 1099 received from manufacturers, or from a cash receipts journal. The lack of control over the books and records may lead to underreported income. A detailed description of how income is recorded by the contractor and the techniques the agent can use to find unreported income appears in Chapter 8 of this guide.

While not as significant as the income issue, expenses should not be overlooked. Cash expenditures evidenced by little or no documentation are also common. A detailed description of contractor expenses appears in Chapter 9 of this guide.

This page intentionally left blank.

Chapter 5

EMPLOYEES

INTRODUCTION

Garment contractors are engaged in a labor intensive business, dependent on the skills of a generally mobile pool of employees to fulfill their contracts. Wages paid in the industry, however, are uniformly low. Layoffs are inevitable when seasonal demand decreases. This section seeks only to describe the nature of the labor pool encountered in the industry. Employment tax issues related to this narrative will be addressed in Chapter 10.

TYPES OF EMPLOYEES

Employees hired by sewing contractors include:

1. A floor lady; sometimes the owner or spouse, to oversee operations.

2. Machine operators for straight stitch, overlock, sew overlock, button, buttonhole, and specialty sewing machines.

3. Pressers or ironers.

4. Finishing and inspecting personnel, to clip threads, and insure quality.

5. Ticketers to affix manufacturer and retail tags.

6. Baggers; finished goods are generally delivered on hangers encased in plastic bags.

7. Pickup and delivery people; usually the owner in smaller establishments.

8. A janitor.

In larger establishments, individuals will be hired to move bundles through the manufacturing process in plants using the bundle system. In smaller businesses, employees may perform more than one job.

Employees hired by cutting contractors include:

1. Cutters, who cut the spread as indicated by the marker. They will also mark or drill the cut.

2. Spreaders, to lay out or spread the fabric on the table to the length of the marker.

3. A foreman, to oversee the operation. This may be the owner in smaller establishments.

4. Strappers and ticketers to bundle and label the pieces cut.

5. A janitor.

6. Pickup and delivery personnel.

Again, depending on the size of the operation, employees may perform more than one function.

COMPENSATION DETERMINATION

Compensation is computed either by hourly rates or on a piecework basis. A cutting contractors' employees are generally all paid on an hourly basis.

A sewing contractors' machine operators and pressers are often paid on a piecework basis, whereas other employees are usually paid on an hourly basis. There appears to be no industry standard, however, and your piecework rates may not be offered by a particular contractor.

When piecework rates are offered, completed work is documented by piecework tickets showing the rate for a particular operation, that is, collar make, collar set, etc., and the number of units completed. These records must be supplemented by a time card record indicating the hours worked during the period because the law mandates the payment of minimum wage; if the piece work rates do not equal or surpass the hourly minimum wage rates, it is required that the minimum wage be paid in lieu of piecework earnings.

Despite these labor laws wages, they may be less than hourly minimum rates and without premium for overtime.

COMPENSATION METHODS

Compensation is usually paid weekly. Payments may be made either by check or in cash.

Payments made by check generally are treated as wages for purposes of income tax withholding and FICA taxes and reported as such on the income and employment tax returns.

Cash payments should be treated similarly, but there is a potential for abuse. For instance, cash wages may go unreported for withholding and employment tax purposes, while being claimed as deductible for income tax purposes.

Records of cash payments may be maintained and can take the form of time cards, disbursement lists, or piecework tickets.

WORK DONE OFF THE PREMISES

Additional labor costs may be claimed for work done off the premises and it is important to determine the nature of such costs early in the examination.

Some work may be subcontracted to other contractors, usually for a few cents less per piece than is received from the manufacturer. Subcontracting is generally infrequent and occurs when a contractor takes on more work than can timely be delivered to the manufacturer.

Other costs, usually spread throughout the year, and represented as "homework," are deducted for labor on the tax return. Homework, in apparel related industries, with some exceptions, has long been prohibited under Federal law and the laws of some states as well.

To be a homeworker, an individual must not be an employee under the usual common law rules applicable in determining the employer/employee relationship. The use of homeworkers nevertheless persists in the industry.

In addition, the individual must meet the following six conditions under IRC section 3121(d)(3), formerly section 3121(d)(4), of the Internal Revenue Code of 1986:

1. The contract of service anticipates that substantially all of the services will be performed personally;

2. The individual has no substantial investment in facilities other than transportation facilities used in performing the service;

3. There is a continuing work relationship with the person for whom the services are performed;

4. The individual performs the services in accordance with the specifications of the person for whom the services are performed;

5. The individual works with materials and goods furnished by the person for whom the services are performed;

6. The individual returns the finished product to the person for whom the services are performed or to a person designated by that person.

See also, Treasury Regulation section 31.3121(d)-1(d).

Revenue Ruling 72-88, 1972-1 C.B. 319, concluded that the investment in sewing equipment and small tools by a tailor, hired by certain "merchant tailors" and working at home, did not constitute a significant investment for purposes of IRC section 3121(d)(3) and viewed the services as personally rendered although he or she was occasionally provided with assistance by members of his or her family. The tailor was considered a statutory employee for purposes of FICA, but not for FUTA or income tax withholding.

See Chapter 10 for further discussion of subcontractors, homeworkers, and the employment tax considerations.

Chapter 6

ACCUMULATION OF INFORMATION BEFORE STARTING THE AUDIT

INTRODUCTION

This chapter focuses on accumulating information to verify the contractor's taxable income. Although the section on examining income will discuss other means of identifying manufacturers for whom the taxpayer transacted business, and who will, therefore, be valuable sources of payment information, this section discusses information sources that are available to the examiner before the first contact with the taxpayer. Having this information at the start of the examination gives the examiner a tool to construct a very effective first interview.

In a General Program setting, an examiner has little information in the examination file before the first appointment with the taxpayer. Items that have been accumulated at this stage in most audits are those that have been generated by the Service, for example, the charge-out and labels, a transcript, perhaps an IRP transcript. Of these, the IRP transcript has the best potential of assisting in the income audit, but as most examiners know, these documents rarely give a complete listing of an entity's reportable income items.

Documents from the four sources discussed in this section are those secured from third parties; they are used to identify manufacturers for whom the taxpayer performed services. As discussed in Chapter 8 on examining income, identifying manufacturers is the key to securing information that will help in determining the correct amount of a contractor's income. Toward that end, the following sources should be used for "leads" that may provide names of manufacturers:

1. Canceled checks that were secured from the manufacturer, if they had been secured when a manufacturer was examined (see Chapter 1, Selection Of Contractors For Audit).

2. Documents from the State Division of Labor Standards Enforcement, Department of Industrial Relations.

3. Listing from the "Apparel Sewing Contractors" publication of the JASA Sewing Contractors Group, or similar advertising.

4. Work applications that may have been filed with manufacturers by the contractor (if any of the contractor's manufacturers are already known by examiner).

5. IRS records of Forms 1099 filed in the name of the contractor under audit. Explanations and examples of these items follow.

CANCELED CHECKS SECURED FROM MANUFACTURERS

In some situations, a contractor is selected for audit based on an inspection of the checks it received from a manufacturer, during the audit of that manufacturer (as described in Chapter 1). If this was the case, then a careful review of the canceled checks particularly the endorsements, would be appropriate before the first meeting with the contractor. The endorsements would give the examiner information such as:

1. Bank accounts into which some checks are deposited. In the audit, the contractor may not willingly tell the examiner about all bank accounts into which receipts are deposited; in the search for manufacturers, there is a high probability that deposited items from some or all of the identified accounts may be summoned. The more bank accounts identified, generally, provide additional manufacturer names.

2. The methods which the contractor negotiates the checks received from manufacturers. Sometimes, all checks from a particular manufacturer are negotiated in the same manner, for example, all deposited to one account, or all cashed at a particular check CASHIER. Just as often, however, checks from a particular manufacturer are negotiated in a variety of ways.

3. Whether the negotiation of the checks is accomplished by the principal, an employee, or a relative.

4. The percentage of checks deposited versus checks cashed.

5. Perhaps an address or a driver's license number that may be useful when trying to identify and locate an owner of a contracting business.

In addition to helping the examiner identify manufacturers, the information that can be obtained from reviewing the checks can help structure specific interview questions that will be useful in the development of audit issues and verifying information supplied by the taxpayer.

DOCUMENTS FROM THE DIVISION OF LABOR STANDARDS ENFORCEMENT, DEPARTMENT OF INDUSTRIAL RELATIONS

The Division of Labor Standards Enforcement is concerned with state regulation of labor practices of garment employers. Its enforcement of registration requirements, wage rates, and employee pay records results in documents that may give the examiner additional manufacturer names for follow-up.

Registration and the Registration Application

All entities engaged in garment manufacturing in California and New York are required to register with the state. (State laws may differ.) "Garment manufacturing means sewing, cutting, making, processing, repairing, finishing, assembling, or otherwise preparing any garment or any article of wearing apparel or accessories designed or intended to be worn by an individual, including clothing, hats, gloves, handbags, hosiery, ties, scarves, and belts * * *." Once registered, a garment entity will be issued a certificate which it displays at its place of business, and which must be renewed annually. Of interest to the examiner, however, is the application for registration which must be completed by the taxpayer. Look for the section of the application which asks for names and addresses of all garment entities with which taxpayer transacts business. In fact, the state processes the applications with only one or two entries in this space; it should not be relied upon as a complete listing, but it is a source of manufacturer names.

Citations and Penalties

When an enforcement officer visits a garment entity and finds violations, he or she issues a citation to the employer. In addition, the enforcement officer will complete a Garment Penalty Assessment Order), which details the violations and the computation of the penalty to be assessed. Either of these documents will include the name of the manufacturer whose goods were being processed by the taxpayer when the enforcement officer made an inspection of the premises.

The Examiner will have to issue a summons to the California Department of Industrial Relations to obtain registration applications and citations as may be required in most states. The examiner should follow general IRS procedures for issuing summons for this type of information.

COMMERCIAL DIRECTORIES AND ADVERTISING

Advertisements placed by the contractor can be extremely helpful in providing background information about the entity under audit. For example, the JASA Sewing Contractors Group annually publishes an "Apparel Contractors" guide for the Los Angeles area. It contains listings of approximately 300 different contractors. In addition to general identification information, the listing also includes specific equipment available, the California garment industry registration number, and most importantly, names of manufacturers for whom the contractor has performed services. The garment specialty group has current and past copies of this publication.

WORK APPLICATIONS SECURED FROM MANUFACTURERS

Some manufacturers require a prospective new contractor to complete an application form, which often requests names of other manufacturers for whom the contractor had provided services. Whenever a manufacturer is asked to supply payment summaries or canceled checks pertaining to a specific contractor, copies of any work applications (if any were filed) should be requested as well. If one was filed with the manufacturer, it would likely include names of others for the examiner to contact for payment information.

IRS RECORDS OF FORM 1099

IDRS command IRPTRE will provide a list of Forms 1099 filed for the contractor's taxpayer identification number, thus naming the issuing manufacturers. If the contractor is a sole proprietor, IRPTRE transcripts should be requested under the contractor's EIN as well as its SSN.

Although Forms 1099 are not required for corporate entities, many manufacturers issue them to all contractors, regardless of the form of their organization. Therefore, IRPTRE transcripts should be requested even for corporate contractors.

Chapter 7

INTERVIEW

IMPORTANCE OF THE INTERVIEW

All techniques in this Guide have been used extensively in income tax audits of contractors. The quality of the initial interview will affect the overall quality and success of the entire examination. A detailed and specific interview plan is necessary for each audit. Sometimes follow-up interviews will be needed to verify information provided with the examination results.

WHO TO INTERVIEW

Examiners should attempt to directly interview the taxpayer. However, the taxpayer is allowed to be represented by another, usually an attorney, certified public accountant, or enrolled agent. If the principal appears without a representative, IRC section 7521(b)(2) requires an examiner to suspend an interview if the taxpayer requests to consult with a representative or seek advice. The examiner may not require a taxpayer to accompany the representative to an interview in the absence of an administrative summons, IRC section 7521(c).

The examiner should request the taxpayer's presence at the interview if the information required such specificity and detail that only the taxpayer will be able to supply it. Accountants and attorneys can often give general answers based on their overall understanding of an industry, and they can answer interview questions "to the best of my knowledge." However, they cannot provide detailed, complete answers to the examiner's questions because they are not deeply involved with the taxpayer's business.

A related reason for requiring the taxpayer's presence is that contractors have been known to use nominees. In such cases, the nominees hold themselves out as the agent of the principal of the business, but they usually have little knowledge of operations. A detailed interview could determine whether a nominee is appearing on behalf of the taxpayer.

If a pre-interview contact finds that the taxpayer is not fluent in English, the examiner should consider having a bilingual Service employee attend the interview to translate. In the event that a Service employee is unavailable, and the representative must translate, the examiner should have the representative sign a copy of the interview notes, attesting that the responses were those of the client. Of course, this alternative is second to having a Service employee as an interpreter.

A REVIEW OF BASIC TECHNIQUES

The purpose of your interview is to secure a general financial picture of the taxpayers business, and to familiarize yourself with the business operation and record keeping practices. A taxpayer may be more responsive to questions early in the examination process than later. After issues are developed, taxpayers are less likely to be fully cooperative in providing information.

Planning is essential to the success of the interview. An outline or questionnaire should be prepared, keeping in mind your objectives and the results of your pre-contact analysis and other available information. If a pro forma questionnaire is used as an aid, it should be rewritten specifically for the case at hand. The completed document should be a flexible guideline that will assist but not restrict your interview.

Your questioning must be thorough and specific and the responses accurately and completely recorded. State questions simply and be certain that they are understood, repeating and rephrasing, if necessary, to be sure that answers are complete and responsive. Listen carefully to the taxpayer and be sure you understand the answers given. Repeat the taxpayer's response if necessary to be sure that you are recording it as the taxpayer intended. Your documentation should be sufficient to provide an accurate and retrievable record rather than a transcript of the conversation.

Follow up on any conflicts or discrepancies in the testimony as they occur and on any leads that are presented.

The questions you ask should generally enable you to obtain the background of the taxpayer and the taxpayer's business, to familiarize yourself with the business operation, to understand the accounting system, to determine whose responsible for record keeping, and to identify sources of income.

GARMENT CONTRACTOR INTERVIEW GUIDELINES AND SUGGESTED QUESTIONS

When interviewing garment industry contractors, emphasis should be given to the areas where non-compliance has proven to be the highest and to those areas which may, at a later date, be presented as a defense against understatement of income.

A partial list of questions to ask during your interview follows. The particular circumstances of an individual case, including data accumulated prior to the interview, will suggest alterations and additions in these questions. The listing primarily concerns sewing contractors but is easily adapted to other types of garment contractor operations.

Business Operations:

- How long has the taxpayer been in the business?
- Has the taxpayer operated at any other location or under another D.B.A.?
- Have changes been made in the operation, for example, space, equipment, etc.?
- What manufacturers are contracted with - then, prior and currently?
- What is the number and kind of machines in the shop?
- When were machines added, scrapped, or sold?
- How busy are they kept? What percent of capacity and how many hours a day?
- How is compensation for a job set? Can they negotiate a price with a manufacturer?
- How many pieces can be cut or sewn per hour per employee?
- What is their margin and direct labor cost?
- How is a job secured and work scheduled?
- Do they pick up and deliver? Are they ever paid for delivery?
- What is supplied by the manufacturer and what must they supply?
- What types of garments do they produce?
- How much are they paid for the average piece or dozen?
- What are the costs to produce the average garment? (There may be cost sheets.)
- What is the annual inventory of supplies?
- How often and quickly do manufacturers pay for work done?
- Is payment by check or in cash?
- Are check payments from manufacturers always deposited or are some cashed?
- What accounts are checks deposited?

- What approximate portion of checks received are cashed?
- Where (specific name and location) are checks cashed?
- Is cash ever redeposited into the bank accounts? If so, how often?
- Why would you cash a check from a manufacturer and then deposit the cash?

<u>Labor:</u>

- Do they ever subcontract or refuse excess work?
- Is all labor included on the tax return?
- Is all labor included on the employment tax returns?
- Is there any labor paid with cash, without withholding for FICA and FUTA?
- Was there overtime worked?
- Were payments made by check or in cash for wages and other labor?
- Were Forms W-2 and 1099 issued to employees?
- Was there any homework?

<u>Note:</u> If there is any indication of cash labor, subcontract or homework, the examiner should analyze whether the workers are employees or independent contractors under the usual common law rules. Guidelines and explanations can be found in IRM 4646 and Exhibits 4640-1 and 2.

<u>Records:</u>

- What accounting method is used?
- What books are maintained?
- What other types of records are kept, for example, time cards, piecework tickets, invoice copies, cost sheets?
- Who keeps the records?
- How and when is income recorded? Who records it and where?
- What records are supplied to the bookkeeper or preparer by the taxpayer? Are

expenses paid by check or in cash?

- What records are maintained for payments in cash?
- Are checks received written to the D.B.A. or to the proprietor?
- Is Form 1099 information relied on to report income?
- Did all manufacturers provide Forms 1099?
- Are bank deposits relied on to report income?

Although many of the questions described above are directed towards the verification of gross income, the following general questions regarding income and expenses will be useful when indirect methods must be employed.

Income:

- What amount of cash was on hand at the beginning and end of each audit year?
- What amount of cash was on hand prior to the audit year and presently?
- Do you have a safe deposit box? What does it contain?
- Was there any additional income -- any considered not reportable?
- Were there any non-taxable sources of funds -- for example, refunds, loans, insurance proceeds, gifts, inheritances, repayments, or reimbursements. Note: The sale of assets could give rise to gain.
- Identify all savings, checking, money market accounts, and CDS.
- Identify all loans, investments, assets.

Living Expenses:

Identify personal expenses -- use a Form 4822 as a guideline and determine if expenses are paid in cash or by check.

TOURING THE PREMISES

A tour of the business premises during the workday will enable the examiner to get a clear idea of the production operation and may provide information that will be of use in development of issues.

Some specific items that you will want to note at this time and perhaps tie into your interview are reviewed below.

- Labels on work in process and finished goods on racks.

- Labels on samples on hand. Be sure to inquire about the name of a manufacturer associated with an unfamiliar label name. It may be a private store label or one of many used by a manufacturer doing business under another name.

- Manufacturers' business cards with telephone numbers are often posted on the wall by the phone. Likewise, manufacturers' cutting tickets or rework orders are often left on desks and boxes, and hangers and bags often reflect manufacturers' names.

- Note how many work stations are available and how many are in use. Ask if this is typical or is it a busy or a slow season.

- Note how many machines there are and find out if any are new. Look at the time cards. Are there as many cards as people working? If there are fewer cards than people, it may indicate a cash, piecework payroll. More cards than people might mean the staff was prepared for your visit or will work another shift. This might be done to minimize the impression of shop volume or simply because the taxpayer confused IRS with INS.

Chapter 8

EXAMINING INCOME

INCOME REPORTING METHODS

There is no uniformity of income accounting records among garment contractors. The examiner should be prepared to deal with the various methods used by contractors to report income. The exact income reporting method used can generally not be determined until the first appointment, when the books and records are first reviewed. The most common types of income reporting methods appear below. The list covers the majority of methods a contractor may use, but it is not intended to be exhaustive.

Bank Deposits

The contractor reports all deposits in the business bank accounts as income. This method can be found in both single and double entry systems of accounting. The method assumes that all income is deposited. There is usually no cash receipts journal maintained to break down each deposit by individual payer (that is, manufacturer) and amount. This is the most common method used by contractors.

Forms 1099 Received From Manufacturers

The contractor simply adds up Forms 1099 received and claims the total as income at the end of the year. This method assumes that all required Forms 1099 were issued and that the contractor included all of them in income. Often, the income number derived from Forms 1099 is not tied in with the bank deposit total so that a discrepancy exists between the two.

Cash Receipts

The contractor breaks down each deposit by individual payer and amount. The assumption is that all amounts received are listed in the cash receipts journal. Amounts in the cash receipts journal should tie in with specific deposits in the business bank account(s). This is the least common method used by contractors.

LACK OF INTERNAL CONTROL

The vast majority of garment contractors are small operations as such, may lack adequate record keeping controls. This should be of particular concern to the examiner when verifying the contractor's income, and usually necessitates the use of special audit techniques to verify or reconstruct income (techniques will be discussed later).

Despite this potential problem, there are proven techniques to detect unreported income. For instance, virtually all manufacturers pay contractors by check, as opposed to cash. Paying by check creates an audit trail that starts at the manufacturer and ends at the contractor. Theoretically, if the examiner locates all manufacturers that the contractor did work for during the taxable year in question, the total gross income of the contractor can be reconstructed from checks issued by the identified manufacturers (income sources). Thus, there is heavy reliance on manufacturers as the source of information to verify income. The following is a discussion of the "how to" in reconstructing a contractor's gross income based on third party contacts with manufacturers.

AUDIT TECHNIQUES

To determine how much, if any, income has been underreported by contractors, the agent should follow a three step process. These steps are:

Step 1: Identify the manufacturers the contractor did work for during the period in question.

Step 2: Make a third party contact with the manufacturers identified in Step 1.

Step 3: Compute the understatement of income based on information obtained from the manufacturer contacts made in Step 2.

How to go about accomplishing each of the above three steps will be discussed in detail below.

1. Identifying Manufacturers

Identifying all manufacturers is THE KEY to verifying a contractor's gross income.

The methods for identifying manufacturers that are listed below can be used regardless of how the contractor case was originated. The methods apply whether the return was selected for audit by the Service Center as a DIF return, or based on the agent's inspection of canceled checks at the manufacturer level and "spun-off."

a. Interview of the Contractor

During the initial interview, be sure to ask the taxpayer for the manufacturers for which work was performed during the year(s) in question. Have the taxpayer refer to business card files if necessary. Also, inquire about manufacturers the contractor currently does work for -- services may have been performed for the same manufacturer during the audit year. (A complete discussion of the initial interview appears in Chapter 6.)

b. Factory Walk Through

After the initial interview is completed at the taxpayer's place of business, tour the premises. As noted in Chapter 6, "Interview," among other things, you will want to note the manufacturers' names and registration numbers on the labels of work in process and finished goods hanging on the racks. Also, note any manufacturer business cards that are hanging on the wall (usually in the office area). Again, the theory here is that the contractor may have performed services for these same manufacturers in prior years.

A word of caution regarding items "a" and "b" above. A single manufacturer may use several different labels for different lines of clothes. Be sure to ask which name the manufacturer is doing business under if you don't already know. This will assist in locating the manufacturer in question.

c. Bank Deposits

A good source of leads on manufacturers comes from summoning the deposit slips and deposited checks of the contractor. This technique will identify manufacturers checks that were deposited by the contractor. By looking at the names and addresses on the checks, the examiner will be able to develop a list of possible leads. Keep in mind that the emphasis here is to identify names, not necessarily unreported income. All it takes is one deposited manufacturer check to identify a lead. The manufacturer can then be contacted as a third party to provide copies of all the checks written to the contractor during the audit year. The check copies can then be used to determine whether income has been understated. It should be noted that even in instances where the contractor maintains a separate business account, business checks may be deposited in the contractor's personal account. Therefore, both business and personal accounts should be summoned.

In the case of larger contractors, deposits are usually large and frequent. The time and cost to all parties involved in the audit can be reduced by eliminating irrelevant, immaterial, and previously identified deposits. Cost can also be reduced by SAMPLING selected deposits (for example, every other deposit or every other month's deposits, etc.). Sampling is a cost effective way to get reliable information. The trade-off, of course, is that you may miss a lead where only one or two checks were deposited from a particular manufacturer. Considerable time, thought, and judgment should, therefore, go into any summons BEFORE information is requested. When you consider that some banks take 3 to 4 months to provide deposit information, asking for only information that is needed saves time and money. BE SURE TO SUMMON ONLY CHECKS DEPOSITED, NOT CHECKS WRITTEN. SINCE THE BANK IS A THIRD PARTY RECORD-KEEPER, THE TAXPAYER MUST BE GIVEN NOTICE OF THE ACTION FOLLOWING THE PROCEDURES

AND TIME FRAMES PRESCRIBED BY IRC SECTION 7609.

d. Cash Receipts Journal (if applicable)

Many contractors, even those who maintain a double entry set of books, do not maintain a cash receipts journal. Rather, they book income directly from bank statements, or Forms 1099 at year-end to the general ledger. However, in those instances where a cash receipts journal (CRJ) does exist, it can be used as a ready source of manufacturer leads.

e. California Division of Labor Standards Enforcement
[Note: State Labor Laws may vary]

The California Division of Labor Standards Enforcement "Application for Registration in the Garment Industry," which must be completed annually, asks contractors to list the names and addresses of all garment entities with whom the taxpayer transacts business. Although the list is rarely complete, it is a source of leads to manufacturers that the contractor did business with at or near the time of renewal.

Citations and penalties issued by a Department of Labor enforcement officer include a listing of the names of the manufacturer whose goods were being processed by the taxpayer, when the officer made an inspection of the premises. This too is a source of leads. (For more information on California Division of Labor Enforcement information and how to obtain it, see Chapter 6, "Accumulation of Information Before Starting the Audit.")

f. Commercial Directories

If the taxpayer lists an advertisement in "Apparel Sewing Contractors," a publication of the JASA Sewing Contractor Group, it can be helpful in developing leads. The "references" section of the contractor ad lists manufacturers for whom he or she has worked. These can be used as leads.

Another directory that can be useful is published by the Textile Association of Los Angeles (TALA). The TALA directory can be used in locating manufacturer leads based on label names. Therefore, if a manufacturer's label name is obtained in a factory walk-through of a contractor, that manufacturer may be located in the TALA directory for a third party contact.

A group specializing in audits of garment returns may have a directory of manufacturers' registration numbers (RNs) and labels. This would be useful if a walk-through resulted in RN or label name identification, but the contractor could not or would not specify the name of the manufacturer.

2. Contacting Manufacturers to Request Documentation of Payments to Contractors

After leads on manufacturers have been developed, each manufacturer selected for follow-up must be contacted to request additional documentation relating to contractor payments. The typical documents that the manufacturer would maintain on any contractor are:

a. Invoices issued by the contractor -- usually located by vendor file.

b. Canceled checks -- located by way of the cash disbursements journal or Form 1099 schedule of payments.

c. Schedule of Payments (for Form 1099 purposes) -- a manually prepared schedule may contain inaccuracies so it should be double checked against the cash disbursements journal for completeness and accuracy.

Obviously, the canceled checks are of utmost importance. They will evidence total payments as well as indications of cashed checks. The contractor's invoices will normally not disclose any more information than the canceled checks. Invoices should be checked for unusual notations or inconsistencies. The Form 1099 payment schedules, if accurate, can save the agent from scheduling contractor payments.

The manufacturers, once located, can be contacted by phone or in writing, using a third party letter. When contact is made by phone, the examiner should identify himself or herself and request to talk to the person in the accounting department responsible for recording and summarizing contractor payments. Phone contact allows you to quickly sift through the organizational structure and locate the one person who can help you. The disadvantage is that an oral request may be forgotten or misunderstood.

A letter does not have the advantage of direct contact with the person responsible for readying the information. However, it does have the advantage of placing the request in writing so that management can see that your request is met, and accounting personnel can repeatedly refer to the agent's instructions.

Some manufacturers require a written request before they will provide the information. All such requests should be honored.

A request for manufacturer information by summons is usually only necessary in two situations:

a. The manufacturer refuses to provide the information after contact by phone or by letter.

b. The manufacturer requests reimbursement for research time and copying costs

(IRS requires a summons before reimbursement is paid).

Should the examiner review, schedule, and copy the documents himself or herself, or should he or she rely on the manufacturer to do the work? While having the manufacturer extract the necessary information is convenient and time saving for the agent, it is unreliable. Mistakes or misunderstandings by the manufacturer's personnel may lead to inaccurate or incomplete schedules, and missing supporting checks or invoices. Also, if the manufacturer still does business with the contractor, he or she may feel a need to "protect" that contractor by providing only deposited checks and omitting cashed checks.

Preferably, the examiner should extract the needed information, but if there are a large number of manufacturer leads relating to one contractor case, it may become necessary to rely on third parties to pull some of the needed documents. Judgment should be exercised by the examiner and his or her manager in making that determination.

3. Computation of the Income Understatement

As a result of third party contacts with the manufacturers for whom the contractor performed services, the examiner will secure copies of all checks that were paid to the contractor during the years under audit. Thus, the examiner will reconstruct the contractor's income by specific item. This audit approach is often referred to as the specific item method. The understatement of income, as determined under this method, is computed as follows:

Unreported Income = Total reconstructed income per audit (the total of all checks from Manufacturers) Minus Gross Receipts per the tax return.

Generally, the same computation is used regardless of the manner in which the contractor has reported its income (for example, based on bank deposits, Forms 1099 or cash receipts journal). The exclusive use of specific items as the basis for determining the unreported income offers little room for argument on the part of the contractor.

As previously noted, it is common in this industry for proprietors of contractor businesses to cash some portion of the checks they receive from manufacturers rather than depositing all the checks into the business account. The proprietor may cash checks for any number of reasons such as to avoid a bank "hold" period or to pay laborers in cash. Even after the checks are cashed, a portion of the currency may be deposited in a business account. This is especially true when checks are cashed to avoid bank "hold" periods. If the examiner secures all checks received by the contractor from all sources, there is no need to factor the cash deposits into the computation of unreported income. The cash was simply obtained from the negotiation of checks that the examiner has already included in the reconstruction. This suggested computation assumes that all of the contractor's income is paid via check. If the examiner should find that the contractor was paid any income in the form of cash, it would be best to verify the total currency receipts through third party contact with the entities that paid the contractor in cash. These amounts would then be added to the "total reconstructed income per audit." On the other hand, if there is a potential that the contractor was paid in cash, but the payers are unknown, the examiner should analyze the dates of the currency deposits in relation to the dates of cashed receipt checks. The examiner should identify currency deposits that are not traceable (via related date) to a cashed check. These "unidentified" currency deposits would then be added to the "total reconstructed income per audit."

The analysis of currency deposits may also aid the examiner in evaluating whether cash wages were paid but not deducted. This information would enable the examiner to more accurately determine the amount of "cash available" for the payment of cash wages.

TAXPAYER EXPLANATIONS OF UNREPORTED INCOME

It is very important to find out what reasons, if any, the taxpayer has to explain why income is underreported. A taxpayer that suggests the unreported checks were cashed and used to pay expenses, usually cash wages, creating a "wash." The taxpayer must also substantiate that these expenses were actually incurred and paid. Cash wages that are substantiated may create an employment tax liability.

The important point is that the explanation should be solicited, analyzed for reasonableness, verified, and properly documented. The final conclusion should be clearly stated in the examiner's work papers.

This page intentionally left blank.

Chapter 9

EXAMINING EXPENSES

ACCOUNTING RECORDS

Journals

In the majority of cases, a contractor will have an accountant or bookkeeper prepare and maintain a ledger or worksheet from which the return is prepared. The journals will usually be a simple cash disbursement registers. It is rare that a double entry set of books will be used unless the contractor is fairly large. However, the accuracy of these journals depends upon the source of the entries. In many cases, the source of entries will be from the check stubs which are attached to the check. Typically, rather than completing all the information on the check stub as to the payee, date, and amount, the contractor will simply write the type of account to which the expenditure is charged. The examiner should ensure that personal expenses are not charged to these accounts.

Invoices/Receipts

If there is a lack of accounting controls within a contractor's business, there may be missing invoices to verify expenses. This may also be the case for expenses that are paid by cash.

Payroll Tax Records

The primary records available are the employment tax returns and the payroll checks. Formal payroll records may include a payroll journal, worksheets showing withholding and deductions, and possibly time cards.

Other Records

At times the contractor may have contracts for the lease of building space or for the lease of sewing machines.

AUDIT TECHNIQUES/OBSERVATIONS

Standard audit techniques may be used to examine contractor expenses.

1. Overstated expenses:

   Expenses reported on the tax return are sometimes larger than those expenses which have been recorded in the check disbursements journal or worksheets.

There may be several reasons for this difference. One reason may be that the contractor is accounting for cash expenditures for which no receipts or invoices are available.

Another reason is that a tax return may have been prepared using a combination of check disbursements and available receipts or invoices. Double deductions for the same expense may result when the receipts or invoices have been paid by check and are also used as sources for additional deductions.

Overstating expenses can usually be discovered through a reconciliation of the disbursement source with the tax return. In those cases where there are a large number of accounts, the total business expenses in the check disbursements journal should be compared with the total expenses claimed on the tax return minus any depreciation claimed. These amounts should reconcile to one another. If there is a significant difference (with the tax amounts being larger than the book), then line by line items should be compared for the differences.

2. Personal Expenses:

   Personal expenses may be paid out of a business account. These expenses should be classified as personal by the accountant or simply added to a nondeductible drawing account. However, in some cases an accountant will prepare monthly or quarterly disbursement entries from check stubs rather than canceled checks. In these cases, insufficient information is recorded on the stubs to allow the accountant to distinguish personal from business expenditures.

3. Returned Checks:

   In some cases, checks written for business expenses are returned due to insufficient funds. This presents a problem if no bank reconciliation is made to account for returned checks. With no bank reconciliation, there is a possibility that the accountant will not be aware of the returned checks. If a check is returned, then the expense is not deductible for a cash basis taxpayer unless another payment has been made. In these cases, two checks may represent payments for the same expense. Checks should be examined carefully for stamps which notate insufficient funds.

4. Auto/Truck Expenses:

   Contractors will often use a vehicle for pick up and delivery, and it is most commonly a van. It is unlikely that an automobile is used for delivery or other business uses 100 percent of the time. This is especially true if the contractor is located within close proximity to the various manufacturers they service. As with all auto issues, it is up to the individual agent to determine business versus personal portions of any vehicles used. Of course, the taxpayer should provide the proper substantiation for these deductions.

5. Travel and Entertainment:

   Although possible, it is not customary for contractors and manufacturers to socialize even for business purposes. However, a taxpayer should be allowed travel and entertainment expenses that are properly substantiated.

6. Subcontract Expense:

   When contractors cannot accommodate all the work received from a manufacturer, they may subcontract the extra work to another sewing contractor. In this event, payment to these contractors is a valid deductible expense. However, this account may also be used to report wages paid to regular employees or to homeworkers outside of normal payroll procedures. There are potential backup withholding and employment tax implications for payments to subcontractors and for payments to employees and homeworkers outside of normal payroll procedures.

This page intentionally left blank.

Chapter 10

EMPLOYMENT TAXES

ISSUES GENERALLY ENCOUNTERED

The examination of garment contractor returns often produces significant employment tax issues. For instance, some wages may be paid without consideration of employment or income tax withholding. Such wage payments may be paid by check in the amount of gross earnings, but usually are claimed paid in the form of cash. Payment in either form is referred to in the industry as "cash wages" as distinguished from the regular payroll from which taxes are withheld and reported.

Contractors offer a variety of explanations for their payment of "cash wages." For example, the payment of wages without proper withholding including:

1. Everybody in the industry does it
2. People refuse to work unless they're paid in cash
3. Workers have no social security number
4. They could not stay in business or make any money if they didn't pay in cash
5. The work was homework.

None of the preceding explanations, however, reduce the employment tax liability.

Occasionally, a contractor will subcontract work out to another shop, incurring a legitimate contract labor expense. Because the contractor must forego all or most of his or her potential profit on the subcontracted lot, the frequency of subcontracting is usually kept to a minimum in an operating shop. However, backup withholding issues sometimes result from payments to subcontractors. See the section "Subcontracted Work" later in this section.

Cash wages paid might be: 1) fully deducted on the tax return as filed or 2) claimed during the course of audit to rebut or offset findings of underreported income or overstated expenses.

CASH WAGES DEDUCTED ON THE RETURN

Cash wages deducted on the return are sometimes deducted in separate expense categories from regular wages. They may also be combined with other expenses and disguised. They may be deducted as labor under cost of goods sold, or as outside contract, contract labor or commissions. If cash wages have been combined with the regular wage deduction, analysis of the relationship between the employment tax returns and wages claimed can provide a strong indication that an employment tax issue is present. Transcripts of the employment tax returns secured prior to examination will verify FICA wages paid, (generally, equivalent to total wages paid) and will confirm the presence of an employment tax issue prior to the initial interview.

Because employment tax issues are so common on contractor cases, consider securing copies of the employment tax returns from the taxpayer at the start of the income tax audit. Also consider protecting the Form 940/941 statutes for the periods that correspond to the income tax year under examination.

CASH WAGES CLAIMED DURING THE EXAMINATION

When the explanation for unreported income is that there are additional cash wages, it is preferable that the contractor provide the amount of those wages before being informed of the amount of unreported income. This will ensure a better chance of determining the proper amount of wages as a contractor will not be tempted to match the amount of wages with the underreported income.

RECORDS OF COMPENSATION PAID

Records offered to verify cash wages can take many forms. The most common ones and some of the associated problems are outlined below.

1. Handwritten weekly records including the name of the worker, often without surname, and the amount paid that week. -- The accuracy of the records are hard to verify, because the employees cannot be sufficiently identified to locate.

2. Handwritten records of style numbers, quantities produced and piecework rates. -- These are usually undated and may or may not identify the worker. This type of documentation provides little substantiation. However, if invoices are available or audit work is done at the manufacturer level, total production amounts may be verifiable.

3. Time cards. -- Time cards are required by law, but are not always used or retained. They should identify the employee and reveal the dates and hours worked. Time cards do not always contain the year, however, and dates and rates are often inaccurate. Further, the cards are not inscribed with the name of the employer.

The lack or presence of will either reduce or enhance the credibility of these documents in substantiating the wages.

4. Piecework tickets. -- They are usually undated, contain a given name or initials, show the number in the batch and the piecework rate. The worker is generally not traceable from the tickets unless supplementary records exist and the volume of such tickets for a year is extraordinary.

5. Canceled checks to individuals. -- These are the best records and sometimes provide sufficient information through endorsements to trace the employees and to ensure the purpose of the payment.

CREDIBILITY OF DOCUMENTATION PRESENTED

When evaluating any of the above items, be sensitive to the credibility of those documents for the purposes of substantiating wages. Always make sure wage amounts are not overstated or deducted more than once. For instance, canceled checks for each employee's wages should match the number of time cards for each employee, and the amount of employees recorded working on any particular day, should generally not exceed the amount of work stations.

Thus, it is important, though often tedious, to study and compare the documents for both duplication and consistency.

Conversely, consistent under-utilization of plant capacity, particularly in combination with the addition of new equipment can be indicative of a cash payroll for on-site employees, and this finding would tend to refute claims of extensive homework.

The contractor's banking records and the manufacturer's payment records will provide an approximation of the contractor's cash flow. This information may be helpful in verifying wage expenses if wages are less than cash flow. On the other hand, if the cash flow does not appear to support wages, the difference could be made up by cash savings or loans.

Information returns are rarely filed by garment contractors for their cash wages, nor are full names, addresses and social security numbers made available for the workers. Unless payments include checks containing endorsements with further information or an occasional Form W-4 surfaces, the workers can be very difficult to trace for purposes of confirming the claimed expense.

Individuals that are more easily traced are those working both "on" and "off" the payroll, since a Form W-2 will be available as well as check endorsements on regular payroll checks. It may prove helpful to interview any identifiable employee or ex-employee.

Any information returns or Forms W-2 secured will, of course, be forwarded for processing and association.

EMPLOYEES OR INDEPENDENT CONTRACTORS

Guides for determining a worker's employment tax status are found in three sections of the Employment Tax Regulations; namely, Treas. Reg. sections 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1, relating to the FICA, the FUTA, and Federal income tax withholding, respectively.

In general, it should be noted that IRC section 3121(d)(2) requires that the application of common law rules in determining the employer-employee relationship. An employer-employee relationship generally exists when the employer exercises sufficient control over the employee. A variety of factors may be used to analyze employment status for tax purposes. Twenty factors have been identified as indicating whether sufficient control is present to establish an employer-employee relationship. The 20 factors have been developed based on an examination of cases and rulings considering whether an individual is an employee. The degree of importance of each factor varies depending on the occupation and the factual context in which services are performed. The regulations provide that the employer's right to control the manner in which the work is performed is the most important. These factors are set forth and are explained in Rev. Rul. 87-41, 1987-1 C.B. 296. The 20 factors are not to be applied mechanically, as a scorecard. Rather, they are to be used as an aid in applying the common law. See **Nationwide Mutual Insurance Co. v. Darden**, 112 S. Ct. 1344, 1348 (1992).

Determination of employee versus independent contractor status is relevant with respect to the following tax issues:

1. Whether the employer is liable fr employment taxes, for example, FICA, FUTA, and withholding;

2. Whether a worker is liable for the employee's share of FICA tax;

3. Whether business expenses of the worker must be itemized, are subject to the 2-percent floor on miscellaneous itemized deductions of IRC section 67, or are subject to the limitations of IRC section 62(c);

4. Whether the firm's qualified pension plan must treat the worker as an employee for qualification purposes; and

5. Whether the worker has a right to continuing health care coverage after termination for purposes of the Consolidated Omnibus Reconciliation Act of 1986, P.L. 99-272.

Begin an employment tax audit by determining which of the 20 common law factors listed in Rev. Rul. 87-41 are relevant for determining control in the garment contractor industry. Also consider whether factors not listed in Rev. Rul. 87-41 may be relevant. Having determined the relevant factors, consideration must be given to the relative weight of these factors in determining worker status. Weigh the facts and circumstances of each case to determine worker status accordingly.

HOMEWORKERS

Homework is the performance of specific functions in the manufacturing process (such as sewing) by an individual away from the contractor's factory. To be a homeworker, an individual must not be an employee under the usual common law rules applicable in determining the employer-employee relationship to IRC section 3121(d)(3). Further, the individual must meet the following six conditions under IRC section 3121(d)(3) [formerly IRC 3121(d)(4)]:

1. The contract of service anticipates that substantially all of the services will be performed personally;

2. The individual has no substantial investment in facilities other than transportation facilities used in performing the service;

3. There is a continuing work relationship with the person for whom the services are performed;

4. The individual performs the services in accordance with the specification of the person for whom the services are performed;

5. The individual works with materials and goods furnished by the person for whom the services are performed;

6. The individual returns the finished product to the person for whom the services are performed or to a person designated by that person. See also Treas. Reg. section 31.3121(d)-1(d).

The Report from the House Committee on Ways and Means states that the homeworker provision and the other statutory employee provisions relate to "well-known occupational areas from which much of the present uncertainty and past litigation on this question has evolved" and that the groups were included as statutory employees "to assure the application of the employee tax rate to individuals who work in these occupations." See 1950-2 C.B. at 288.

The legislative history specifically describes homeworkers as follows:

Homeworker -- Included within this occupational group are individuals who fabricate quilts, buttons, gloves, bedspreads, clothing, needlecraft products, etc., or who address envelopes, off the premises of the person for whom such service is performed, under arrangements whereby they obtain from such person the materials or goods with respect to which they are to perform such service and are required to return the processed materials to such person or to a person designated by him. See 1950-2 C.B. 287. Inherent in this description is the understanding that garment workers do not generally maintain a substantial investment in facilities. That is, by singling out these workers in the legislative history, Congress necessarily considered and rejected the notion that the sewing equipment generally necessary to fabricate quilts, bedspreads, clothing, and other needlecraft products constitutes a substantial investment in facilities.

Revenue Ruling 72-88, 1972-1 C.B. 319 concluded that the investment in sewing equipment and small tools by a tailor, hired by certain "merchant tailors" and working at his or her home, did not constitute a significant investment for purposes of IRC section 3121(d)(3) and viewed the services as personally rendered although he or she was occasionally provided with assistance by members of his or her family. The tailor was considered a statutory employee "for purposes of FICA, but not for purpose of FUTA or income tax withholding," as indicated in the head note to the Revenue Ruling.

Although homework is generally illegal in the apparel industry (with exceptions for knitted outerwear, gloves, buttons, handkerchiefs, and some jewelry) its use still continues. Contractors admit to paying homeworkers when they want to characterize payments for services as being made to a nonemployee, or when they try to explain how they pay more workers than the factory can accommodate. Examiners should not be surprised to find that most payments to homeworkers are reported to be in cash, or that most homeworkers are known only by given names, have no known social security numbers, and have no known residence locations.

A true homeworker is not treated as an independent contractor for purposes of employment tax. The examiner must independently determine whether a worker is an "employee" under the usual common law rules. A worker's employee wage payments are subject to FICA, FUTA, and income tax withholding. However, if under the usual common law rules, the examiner concludes that a worker is not an employee, but the worker meets the homeworker test of IRC section 3121(d), that compensation may be subject only to FICA, and only when earnings equal or exceed $100 in a calendar year. Backup withholding (IRC section 3406) may also apply to a homeworker's compensation when his or her TIN was not provided to the payer. If the worker is not an employee and does not meet the homeworker test, the worker is treated as an independent contractor for employment tax purposes.

CONSIDERATION OF RELIEF PROVISIONS

IRC section 3509, allowing relief in cases of the reclassification of employees, will generally be inapplicable to the employment tax cases encountered in the garment industry.

Most contractors report the payment of some payroll and will treat individuals working at the same or similar positions inconsistently. Often, the same individual is treated inconsistently, reported as an employee for one week's work but not for the following week's work or for overtime work. Both of the situations described, as well as any testimony taken from the contractor or his/her employees, can be used to establish intentional disregard and deny the relief provisions of IRC section 3509. Relief is further denied to homeworkers by the provisions of IRC section 3509(d)(3).

SECTION 530 OF INTERNAL REVENUE ACT OF 1978

The following is a brief outline of the law regarding employment status and employment tax relief. It is important to note that either worker classification -- independent contractor or employee -- can be a valid and appropriate business choice. For an in-depth discussion, see the training materials on determining employment status: "Independent contractor or Employee?" Training 3320-103 (Rev. 10-96) TPDS 84238I. The training materials are also available from the IRS Home Page (http://www.irs.ustreas.gov).

The first step in any case involving worker classification is to consider Section 530. Before or at the beginning of any audit inquiry relating to employment status, an agent must provide the taxpayer with a written notice of the provisions of Section 530. If the requirements of Section 530 are met, a business may be entitled to relief from Federal employment tax obligations. Section 530 terminates the businesses's, not the worker's employment tax liability and any interest or penalties attributable to the liability for employment taxes.

In general, the common law rules are applied in determining the employer-employee relationship. IRC section 3121(d)(2). **Nationwide Mutual Insurance Co. v. Darden**, 503 U.S. 318 (1992).

Guides for determining a worker's employment status are found in three substantially similar sections of the Employment Tax Regulations; namely, sections 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1, relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and Federal income tax withholding, respectively.

The regulations provide that the employer's right to control the manner in which the work is performed is the most important factor in analyzing employment status for tax purposes. The examiner will need to weight the facts and circumstances of each case and determine worker status accordingly.

The training materials provide more information on the method of analysis used in determining employment status. They explain the kinds of facts to be considered, including those evidencing behavioral control, those evidencing financial control, and those evidencing the relationship of the parties.

SUBCONTRACTED WORK

To the extent that a contractor substantiates that payments were made for subcontract services the contractor is entitled to deductions. If the contractor did not secure the payees' taxpayer identification numbers and backup withholding under IRC section 3406, it will be required for all non-corporate payees. Ensure that payments to corporations are fully substantiated by requesting all available identifying information about the subcontractors (name, TIN, address, phone number, name of principal), following up on this information with appropriate research to determine its credibility, and setting up whipsaw positions for unagreed cases (not deductible for income tax purposes; subject to backup withholding or additional employment taxes). Backup withholding is addressed in more detail below.

BACKUP WITHHOLDING (IRC SECTION 3406)

Under the backup withholding rules of IRC section 3406, a payer is required to deduct and withhold a certain percentage of the payment if, for example, the recipient of the payment fails to furnish his taxpayer identification number (TIN) to the payer. Additionally, the payor may be required to backup withhold if the IRS notifies the payor that the recipient's TIN is incorrect. For amounts paid after December 31, 1983, but on or before December 31, 1992, the amount required to be deducted and withheld is 20 percent of the payment. For amounts paid after December 31, 1992, the amount required to be deducted and withheld is 31 percent of the payment (see IRC section 1935 of the Energy Policy Act of 1992, P.L. No. 102-486, and Announcement 92-162. 1992-47, I.R.B. 10.)

Backup withholding should be considered in connection with payments made to nonemployees, that is, subcontractors or homeworkers. Payments to nonemployees may be subject to backup withholding if the contractor made payments to a non-corporate subcontractor or a homeworker without securing the payee's TIN or the IRS notified the contractor that the subcontractor's or homeworkers TIN is incorrect.

As already mentioned, one of the key "triggering events" is that the contractor made a reportable payment and the payee did not furnish a TIN to the contractor. This creates a potential backup withholding liability.

For years before January 1, 1994, backup withholding under IRC section 3406 is asserted in the same manner as additional employment taxes, on Form 941. Beginning January 1, 1994, backup withholding is asserted on Form 945.

ABATEMENT CONSIDERATIONS

When income tax withholding is adjusted under IRC section 3402 (income tax collected at source) or IRC section 3406 (backup withholding), IRC section 3402(d) allows abatement of the income tax withheld to the extent that the taxpayer demonstrates that the tax has already been paid (by the payee).

At the time of this revision, the National Director, Specialty Taxes issued a memo dated March 7, 1995, which transmitted supplemental instructions for IRM 4600 (Employment Tax Procedures) with regard to the relief provided by IRC section 3402(d). The supplement authorizes examiners to accept and consider Forms 4669 at the examination level. This means that properly completed Forms 4669 will result in abateable taxes being netted in the preparation of the audit report. Previously, the full amount of the additional taxes were first assessed by Service Centers, then Forms 4669 were evaluated by Services Centers to determine the abatement amounts. The memo referred to above gives interim instructions, pending development of an Employment Tax Examination Handbook that will be used by all the Service's employment tax examiners (Examination, Collection, EP/EO).

TRUST FUND RECOVERY (100 PERCENT) PENALTY STATUTE

If a sole proprietorship or partnership is unable to pay its employment tax (including backup withholding) liabilities in full, the Service must look to the principal for payment. However, cases involving corporations and partnerships, the Service may collect the withholding taxes (employees' share of FICA, income tax withholding, and backup withholding) from "responsible persons" under the authority of IRC section 6672, that is, the Trust Fund Recovery Penalty. A typical example of its application follows.

Example 1

Assume the examination includes the Forms 940 and 941 for 1991

Normal statute for 1991 Form 940 -- January 31, 1995
Normal statute for 1991 Form 941 -- April 15, 1995

If the Service is unable to collect from the corporation and must look to IRC section 6672, only a portion of the Form 941 taxes are potentially collectible, for example, employees' share of FICA and income tax withholding (whether from wages or as backup withholding). Absent a statute extension, the taxes must be assessed against "responsible persons" under IRC section 6672 by April 15, 1995. A corporate statute extension on Form SS-10 does not extend the IRC section 6672 (100 percent penalty) statute.

For any corporate Form 941 case where the corporation cannot pay the additional employment taxes, if the collection officer is assigned the case after April 15, 1995, he or she will not be able to collect any amount, and he or she will have no opportunity to collect from "responsible persons." The 100 percent penalty statute will have expired.

Whenever a corporate contractor's Forms 941 are adjusted in audit and the tax is unpaid at the conclusion of the audit (agreed or unagreed), protect the IRC section 6672 statute by having all "responsible persons" sign statute extension Forms 2750. The extension date would be December 31 of the year following the year in which the statute period will expire (IRM 4684). In the above example, the "extended to" date for the 1991 Forms 941 would be December 31, 1996.

A potentially "responsible person" may refuse to sign a Form 2750, in which case the full amount of the IRC section 6672 penalty would be assessed against that person to protect the Government's interest (after the employment taxes are first assessed against the corporation).

IRM 4684 provides a procedure for examiners to follow if the 100 percent penalty is considered while the case is still in the examiner's possession. It involves making a 100 percent penalty referral to the Collection Division. Local procedures may alter or completely supersede the IRM guidelines.

<u>Note:</u> As this revision was being completed, Chief Counsel had advised that the Internal Revenue Code imposes no assessment statute of limitations for the Trust Fund Recovery Penalty. If the Service prevails in a case currently in litigation because of the Trust Fund Recovery Penalty, new procedures will be issued.

For further information regarding employment tax issues, contact the employment tax coordinator.

Chapter 11

Penalties

BACKGROUND

As with any audit, penalties should be asserted only where the facts and circumstances warrant their application. Examiners should consult IRM (20), the Penalty Handbook, before asserting any civil penalties.

ACCURACY)RELATED PENALTY: IRC SECTION 6662(a)

The accuracy related penalty provides a penalty of 20 percent of the portion of the underpayment attributable to the conduct listed below. See IRC section 6662(a). Special operating rules for this penalty are contained in IRC section 6664. The penalty applies to returns, the due date, for which (determined without regard to extensions), is after December 31, 1989.

NEGLIGENCE OR DISREGARD OF THE RULES OR REGULATIONS

Negligence involves a lack of due care or a failure to do what a reasonable and ordinary prudent person would do under the circumstances. Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code. The term disregard, includes any careless, reckless, or intentional disregard. See IRC section 6662(b)(1).

SUBSTANTIAL UNDERSTATEMENT

There is a substantial understatement of income tax for a taxable year if the understatement exceeds the greater of $5,000 ($10,000 for corporations other than an S-Corporation or a personal holding company) or 10 percent of the tax required to be shown on the return. The understatement is reduced by any portion of the understatement that is attributable to substantial authority or for which there was adequate disclosure. See IRC section 6662(b)(2).

REASONABLE CAUSE

The accuracy-related penalty may not be imposed for any portion of an underpayment if it is shown that there was reasonable cause for that portion of the underpayment and the taxpayer acted in good faith. See IRC section 6664(c).

FRAUD PENALTY: IRC SECTION 6663

The fraud penalty is equal to 75 percent of the underpayment attributable to fraud. To establish a taxpayer's liability for the fraud penalty, the Service must prove by clear and convincing evidence that part of the underpayment was due to fraud.

INFORMATION REPORTING PENALTIES: IRC SECTIONS 6721)6724

Examiners should consider these penalties if the contractor fails to comply with certain information reporting obligations such as filing and furnishing Forms 1099 and W-2. IRC section 6721 provides a penalty, generally $50 per return, for failure to file and failure to provide the correct information on an information return. IRC section 6722 provides a penalty of $50 for each failure to provide a correct payee statement. IRC section 6723 imposes a $50 penalty for each failure to comply with a specified information reporting requirement. The penalties under IRC section 6721 and IRC section 6722 are increased when the failure is due to intentional disregard. IRC section 6724 provides that no penalty shall be imposed if it is shown that the failure is due to reasonable cause and not willful neglect. IRC section 6724 also contains special operating rules.

STATUTE OF LIMITATIONS

Generally, the Service has 3 years from the date an information return is filed to assess an information return penalty. See IRC section 6501(c). If no return is filed, the period of limitations remains open. See IRC section 6501(c)(3).

CRIMINAL REFERRALS

An examiner should consider the following guidelines when determining whether a case should be referred to the Criminal Investigation Division:

1. An examiner conducts a series of taxpayer interviews to determine the sources of income for a particular taxpayer. The examiner collects various source documents to establish this income. The examiner may observe the taxpayer at his or her place of business and may interview third parties (wholesalers, contractors, accountants, etc.) to verify the income. If necessary, the examiner may use a summons for any additional records he or she deems necessary for the audit. Further, an examiner may make observations about the taxpayer's educational background and business sophistication to determine if the taxpayer is the person ultimately responsible for any filed tax returns.

2. When an examiner has been alerted to the possibility of fraud, he or she must know at what point to suspend the examination. If the examiner stops too soon, he or she may not have obtained all of the information needed by Criminal Investigation

(CI) to evaluate the case. The examiner must be able to demonstrate that there is an actual understatement of tax resulting from the findings. To do so, he or she must gather sufficient facts and seek explanations which might account for the discrepancy. Furthermore, the examiner must gather evidence relating to the intent.

3. Once the examiner has discovered firm indications of fraud, the examination should immediately be suspended, without disclosing to the taxpayer or representative the reason for the suspension. The findings should be discussed with his or her group manager at the earliest opportunity. If the manager concurs that there is possible fraud, a meeting will be held with the examiner, group manager, and the District Fraud Coordinator (DFC) to determine whether or not the facts warrant a criminal fraud referral or if the civil fraud penalty should be applied to the case. If the civil fraud penalty is applied, the case will be worked and closed out civilly at the group level. If it is determined that criminal fraud exists, a referral should be made to CI by submitting the Revised Form 2797 (Referral Report of Potential Criminal Fraud Cases). This form should be prepared in accordance with IRM 4565.

This page intentionally left blank.

Chapter 12

COLLECTION AND WHIPSAW ISSUE CONSIDERATIONS

BACKGROUND

Until recently, examiners have concentrated on conducting audits and securing audit report agreements, without giving much thought to whether or how the additional liabilities will be collected. It is important to look ahead to some basic collection considerations. The examiner should be careful when considering a corporate taxpayer's offer to accept a proposed adjustment based on unreported income if the service made a withholding adjustment from "cash wages" that have been asserted by the taxpayer to offset the unreported income. If accepted, the Service could be hindered in collecting the revenue if the corporation dissolves. Under this scenario, the Service would have to proceed under a transferee theory to collect. On the other hand, if the examiner allows a deduction for cash wages (which offsets unreported income) collecting the withholding could be accomplished through IRC section 6672. In addition, the examiner could set up both issues to protect against a potential Whipsaw.

SUMMARY

Of course, an actual case would have its own facts and circumstances which may mitigate the proposed adjustments and increase the likelihood of agreement and payment. Full payment at the time a case is closed from the audit group is always the best option, but failing that, the examiner must weigh collection probabilities when developing and concluding contractor examinations.

This page intentionally left blank.

GLOSSARY

The words included in this listing are those that are likely to arise in the audit of a garment contractor. Explanations of terms are made in this specific context.

ADVANCE -- Partial payment by a manufacturer to a contractor, before all goods are completed. A short-term, non-interest bearing loan from the manufacturer to the contractor.

BUNDLING -- The process of tying together similar pieces of fabric, after they have been cut, in preparation for moving them to the sewing operation. Same as "strapping."

CHECK CASHIER -- A business that exchanges currency for a check. They are located throughout most metropolitan areas, and range in size from single outlet operations to chains that have outlets in many neighborhoods. A fee is charged to the person presenting the check; the fee is based on the amount of the check. A check cashing business may be part of other types of businesses, such as markets and convenience stores.

CMT CONTRACTOR -- Cut, Make, and Trim (CMT) contractors provide all cutting and sewing services and supply trim and findings under a single contract for manufacture.

CONTRACTOR -- An entity that performs a designated operation in the manufacturing process, under contract with a manufacturer. A contractor does not have legal title to the goods. The contractor is paid a negotiated amount per piece or per dozen, and maintains its own workforce, provides its own machinery and equipment, and secures its own facilities.

CONVERTER -- An entity that adds colors and designs to fabric, to produce the specific material that a manufacturer will purchase for a garment. A textile manufacturer may also be a converter.

CUT -- The process of cutting fabric to the shapes required by a pattern. Also, refers to a "batch" moving through the manufacturing process.

CUT NUMBER -- A number assigned by a manufacturer to identify a specific quantity of fabric from the time that it is segregated to be cut, through all manufacturing processes, until the finished garments has been inspected by the manufacturer. A cut number is used in conjunction with a style number, so that any "batch" of goods moving through the manufacturing process is tracked by its cut and style numbers.

CUTTING TICKET -- A document generated by the manufacturer, which is the primary means of tracking goods through the manufacturing process. Some of the critical information included on a cutting ticket: Fabric identification and its quantity, the style number of the garments to be produced, the cut number assigned to the particular "batch" being placed in process, the cutter who will cut the fabric, the contractor who will assemble the garment, completion dates for contractors, and number of units for each size.

DUPLICATES -- Small production runs, usually to produce the garments that will be shown by salespersons.

FINDINGS -- Items which are essential to the construction of the garment in a structural sense, such as pads, zippers, and fasteners.

FLOOR LADY -- Female supervisor in a contractor's factory.

FOREMAN -- Male supervisor in a contractor's factory.

FUSING -- Bonding of fabrics by means of an adhesive and heat, for the purpose of helping a garment retain a shape.

GRADING -- The process of producing consecutively sized patterns from a base pattern.

HOMEWORKER -- An individual who performs specific functions in the manufacturing process (such as sewing or pressing) away from the contractor's factory. An individual who fits the technical definition of "homeworker" is treated differently than an "employee," for purposes of the contractor's employment tax responsibility. However, contractors often treat employees as "homeworkers" resulting in an understatement of the employer's employment tax liability.

KNIFE/KNIFE TRIMMER -- Attached to overlock and sew overlock machines to trim approximately 1/8 inch during the stitching process while the balance of seam is encased and finished.

MANUFACTURER -- The entity that coordinates all aspects of garment production and that sells the garments to retailers. Production functions include designing the garment, securing all components that will make up the finished garment, cutting the fabric, and assembling the garment. Cutting and assembly are examples of operations that are often completed by another entity, under contract with the manufacturer.

MARKER -- A large rectangular piece of paper that designates the placement of pattern parts on fabric that is to be cut. A range of sizes will be included on one marker.

MARKING AND DRILLING -- Making tiny slashes and drill holes in cut fabric, to assist sewing personnel in garment construction.

NOMINEE -- Person who represents the owner of a contracting operation. Although the business may be in a nominee's name, and tax returns and governmental filings indicate the nominal owner is the true owner, the nominee often has little to do with day to day operations or with beneficial ownership.

PIECE GOODS -- Fabric purchased by the manufacturer.

PIECEWORK -- A method of compensation, based on the number of units completed by an employee. Also, refers to a method of garment production (as opposed to "whole garment" construction).

PIECEWORK TICKETS -- Affixed to bundles of cut goods, as they move through the assembly process. They designate the rate at which compensation will be paid and the number of units in each bundle. These tickets are removed by the employee completing each process; they are tallied to determine how many units were completed by the employee, and thus, how much the employee will be paid.

REGISTRATION CERTIFICATE (also referred to as "state registration certificate" or "Montoya certificate") -- Form issued by the state to signify that the entity has complied with the annual registration requirement imposed on all entities engaged in garment manufacturing. It must be displayed at the place of business. Each certificate contains an entity's unique identification number that has been issued for this purpose. This number should not be confused with the entity's Federal or state tax identification numbers, though the format is similar: xx-xxxxxxx.

RN NUMBER -- A registration number assigned to a manufacturer by the Federal Trade Commission. It is often printed on a tag that is sewn into garments, in the format "RN 12345." It should not be confused with an entity's state or Federal tax identification number, or with the garment registration number.

SAMPLES -- Pre-production, one of a kind garments sewn for the manufacturer to test a variety of fabrics, colors, assembly techniques, etc. Frequently, manufactured by the manufacturer, but sometimes contracted out.

SPREADING -- The process of laying out fabric in layers, in preparation for being cut into the shapes dictated by a pattern.

STRAPPING -- The process of tying together similar pieces of fabric, after they have been cut, in preparation for moving them to the sewing operation. Same as "bundling."

STYLE NUMBER -- A unique number assigned by a manufacturer to each style, to distinguish each style from others produced during the current or previous seasons.

SUBCONTRACTOR -- An entity that secures work from a contractor, often when the contractor needs help in meeting a deadline for completion of garments, or when the contractor cannot perform a specialized process in the assembly of a garment.

TRIM --Decorative items on a garment, such as lace, ribbon, or sequins. In its broadest sense, it can include everything that makes up the garment except the shell fabric.