

Market Segment Specialization Program



Scrap Metal Industry

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 3123-001 (2-99)
TPDS No. 84683P

This page intentionally left blank.

Table of Contents

Introduction

General Background Information	1-1
Types of Scrap Metal	1-4
Compliance Issues	1-5

Examination Techniques

Purchasers of Scrap Metal	2-1
Operations of Purchaser	2-1
Major Issues	2-3
Pre-Audit Steps	2-6
Information Document Request	2-7
Interview Questions	2-8
Development Process	2-12
Sellers of Scrap Metal	2-16
Types of Cases	2-16
Major Issues	2-17
Pre-Audit Steps	2-19
Information Document Request	2-21
Interview Questions	2-22
Development Process	2-26

Common Industry Issues (Purchasers & Sellers)

Accumulated Earnings	3-1
Built-In Gains--S Corporations	3-1
Double Deduction of Expenses	3-2
Earned Income Tax Credit	3-2
Employment Tax	3-2
Excise Tax	3-3
Inventory/IRC Section 263A	3-4
Loans to Shareholders	3-4
Special Rules for Long-Term Contracts	3-5
Traffic Tickets and Fines	3-5
Unreasonable Compensation	3-5

Penalties	
Penalties	4-1
Civil Penalties	4-1
Criminal Referrals	4-2
Failure to File Form 8300	4-3
Compliance Strategies	
Coordination with Other Functions	5-1
Coordination with Industry Groups	5-3
Compliance Letter	5-3
Appendix	A-1
Bibliography	A-17
Glossary	G-1

Preface

This audit technique guide was written and compiled, by and for Internal Revenue agents, to be used in the examinations of returns of the scrap metal industry. These examinations include returns for both purchasers and sellers of scrap metal. The purpose of the guide is to promote uniformity and consistency in examinations and in the application of tax laws.

While the information compiled in the guide sets forth a general overview of the industry, it is not intended to be all-inclusive, and agents should consider any local information that pertains to their examinations.

We want to acknowledge our appreciation to the Institute of Scrap Recycling Industries, Inc. (ISRI) for providing us with background information about the industry and allowing us to use excerpts from their publications.

This page intentionally left blank.

Chapter 1

Introduction

General Background Information

Throughout the ages, man has been recycling metals by melting and reusing them. A visit to almost any industrial area in the country will demonstrate that the scrap business is alive and well. You'll notice scrap processors (scrap facilities or scrap yards) where the scrap metal is piled high, cranes are lifting and sorting the metals, and trucks are hauling the scrap metal in and out of the facilities. Recycling metal is important because it creates big business. It also plays an important role in conserving our national resources. It helps keep our highways and cities free from debris and helps preserve landfill space.

In the U.S. alone, scrap metal processors handle the following approximate quantities of scrap metal yearly:

56 million tons of scrap iron and steel;

1.5 million tons of scrap copper;

2.5 million tons of scrap aluminum;

10 million tons of scrap automobiles;

(This is included in the 56 million tons of scrap iron and steel recycled.)

1.3 million tons of scrap lead;

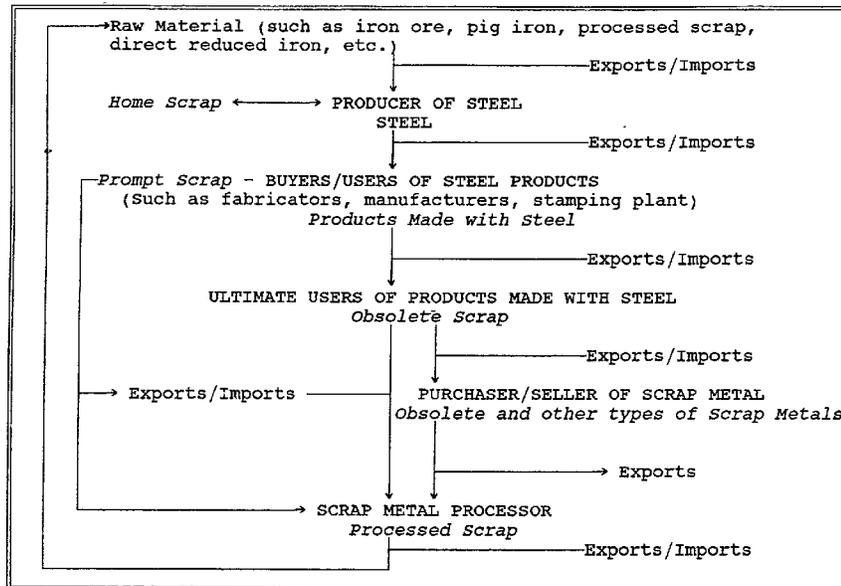
300,000 tons of scrap zinc; and

800,000 tons of stainless steel scrap. ¹

¹ *Scrap: America's Ready Resource*, Institute of Scrap Recycling Industries, Inc., pp. 2-3.

Figure 1-1

A Simplified Scrap Cycle for Steel in the U.S.



The chart above and the example below give a simplified view of the cycle that steel might go through.

Example

Iron ore is extracted from the ground. It is shipped to a mill where iron or steel--steel in this example--is made into different forms, such as sheet or bar stock. The steel is then shipped to a buyer, such as a stamping plant or screw machine shop, to be fabricated. During that fabrication, scrap metal is generated; then, it is sold for processing and/or melting.

Scrap metal is also produced by the ultimate user at the end of the steel product's useful life. The obsolete product enters the recycling system at that point.

After processing the scrap metal, the scrap processor will sell the processed scrap to a mill, foundry, or other concern that will use the metal to make new products.

Examples of commonly recycled scrap metal products are:

- Aeronautical and aerospace equipment, including airplanes and rockets;
- Aluminum siding, doors, and window frames;
- Appliances;
- Automobiles;
- Bed frames and mattress springs;
- Bicycles;
- Bridges;
- Cast iron sinks and bathtubs;
- Computers;
- Cooking pots and pans;
- Electrical wire;
- Elevators;
- Eyeglass frames;
- Farm equipment;
- Food and beverage containers;
- Hospital equipment;
- Industrial cuttings;
- Industrial machinery;
- Locks and doorknobs;
- Office equipment and furniture;
- Park and playground equipment;
- Pipe;
- Railroad and subway cars;
- Roadbed reinforcing bars;
- Roofing;
- Ships;
- Structural steel building frames;
- Telephone wire;
- Tools; and
- Toys.

Scrap recyclers purchase recyclables from various sources, including manufacturers of metal products; airlines and railroad companies; apartment complexes; automobile dismantlers; auto mechanics; builders, roofers, and other construction sources; demolition contractors; factories; mills; foundries; fabricators; farmers; federal, state, and municipal government agencies and programs; hospitals; universities; schools; machinists and appliance repair shops; municipal curbside collection programs; offices; stores; hotels and restaurants; plumbers and electricians; the general public; the U.S. Armed Forces; and utility companies.

Types of Scrap Metal

Scrap metal is divided into two types: ferrous and nonferrous. Ferrous scrap is scrap iron and steel. This includes scrap from old automobiles, farm equipment, household appliances, steel beams, railroad tracks, ships, and food packaging and other containers. Ferrous scrap accounts for the largest volume of metal scrapped. Ferrous scrap is classified into almost 80 grades; additionally, there are another 40 grades of railroad ferrous scrap and even more grades of alloy scrap. Metal alloys are made from a combination of two or more metals.

Nonferrous scrap metal is scrap metal other than iron and steel. While the volume of nonferrous scrap is less than ferrous scrap, it is more valuable by the pound. Here are some examples of nonferrous scrap: aluminum, copper, lead, zinc, nickel, titanium, cobalt, chromium, and precious metals. Millions of tons of nonferrous scrap metal are recovered by processors and consumed by secondary smelter, refiners, ingot makers, fabricators, foundries, and other industries in this country.

Scrap metal, ferrous and nonferrous, can be categorized as either “home scrap” or “purchased scrap.” Home scrap is scrap generated at the mill, refinery, or foundry, and is generally remelted and used again at the same plant. Home scrap never leaves the plant.

The other category, purchased scrap, is further classified as either industrial (also called prompt or new scrap) or obsolete scrap. An example of industrial scrap is a piece of metal that is cut or drilled. The metal that is cut or drilled out and is not incorporated into or made into the finished product is known as industrial scrap. The largest source of industrial scrap is the automotive industry. Obsolete scrap, also referred to as old scrap, is scrap that is worn out or unwanted in its form. Examples of obsolete ferrous scrap are automobile hulks, old farm equipment, and major home appliances. Examples of obsolete nonferrous scrap include radiators and catalytic converters from old automobiles, electrical boards from old computers, old pipes from buildings, and spent photographic film. Recyclers can recover copper and lead from radiators, platinum from automobile catalytic converters, gold from computer electrical boards, and silver from the spent photographic film.

Note: See the glossary for definitions of many of the terms used within this audit guide.

Compliance Issues

Examinations of scrap metal processors have identified areas of noncompliance in this industry. The most common issues encountered in examinations are that deductions for cash purchases of scrap metal were often not adequately substantiated by purchasers and that payments were often not reported in income by sellers of the scrap. It should be noted that some businesses are both purchasers and sellers of scrap metal. For example, a peddler may purchase scrap metal from a manufacturing concern and also sell the scrap metal to a scrap processor.

The section on examination techniques is divided into two sections; one section is on purchasers of scrap metal and the other is on sellers. Following Examination Techniques, is a section on common industry issues. These are issues that may be encountered in examinations of both purchasers and sellers.

This page intentionally left blank.

Chapter 2

Examination Techniques

Purchasers of Scrap Metal

Examples of purchasers of scrap metal are foundries, mills, mini-mills, brokers, peddlers, and scrap processors. The industry prefers either the term “facility” or “plant,” be used to refer to their place of business, but you may also see the term “yard” used.

Operations of Purchasers

Scrap Processors (also known as Scrap Dealers or Scrap Recyclers)

Scrap processors collect, sort, process, and eventually sell the scrap metal to foundries, mills, mini-mills, and other purchasers. Most processors handle both ferrous and nonferrous metals but may specialize in either. Exhibit A identifies the properties of ferrous and nonferrous metals and their sources.

The equipment utilized by the scrap processor to process the scrap will vary with the type and volume of scrap the processor purchases. Most processors will have a crane that is either a traditional cable type or a hydraulic crane that is available on crawler, truck, pedestal, gantry, rail, or overhead mountings. Large magnets or grapples are attached to the cranes that lift and move the ferrous scrap. Processors may have a hydraulic baling press, an alligator shear, or hydraulic guillotine shear. Some processors have shredders that can turn an auto into much smaller pieces of scrap. Because shredders are very expensive machines, there are fewer in number. However, the shredders produce a large volume of tonnage. Additional equipment utilized to process the scrap might include scales, conveyors, mobile auto crushers, and the truck fleets and containers used to store and move the scrap from the originator to the end user.

When the scrap metal arrives at the processor’s location, the scale operator normally weighs the scrap placed on the scale and creates a cash slip/weight ticket. The cash slip/weight ticket generally identifies the type of metal, total weight, price per pound (or per cwt. or per ton), total amount to be paid, and name of the individual or business selling the scrap metal. The cash slip/weight ticket is then presented to the cashier for payment. If the processor services businesses where containers are kept on the seller’s premises, these businesses, often referred to as industrial accounts, normally will be paid once or twice a month.

The scrap market can be volatile. Even experts have a hard time predicting prices for any scrap commodity at any given time. For example, ferrous scrap valued at \$100 a ton in one year can be worth \$50 two years later and \$130 the next year. In this market, the purchaser determines the market price. When demand increases for scrap metal, a higher price is offered to the seller.

When enough scrap has been purchased, the price begins to fall. There is less incentive for the processors to collect scrap when the price is low because the profit is also lower. If the market price of scrap metal is low and processors can afford it, some may stockpile scrap and sell later when the market is more favorable. Thus, inventories may vary depending upon market conditions.

Most scrap processors eventually sell scrap metal to larger processors, foundries, or mills. Payment is usually made by check but can be made by wire transfer or in cash.

Peddlers

A scrap peddler is usually a sole proprietorship reporting on a *Schedule C*. The peddler purchases scrap metal and resells it to the scrap processor. Depending upon the size of the peddler's operation is, the peddler may have drivers working for him to help transport the scrap. The peddler may have industrial accounts at machine shops and stamping plants or may search for scrap metal. A peddler with industrial accounts may maintain containers at the customer's location to store the scrap metal. The peddler is different from the processor because he does not process or store the scrap metal. He merely transports the scrap metal from the seller to the buyer. When a customer calls or the peddler locates scrap metal, the peddler takes the scrap metal to a processor. The peddler may be paid by the processor upon delivery or later with or without an invoice being issued. The peddler usually does not deal exclusively with a specific processor but "shops around" for the best price.

Brokers

Brokers act as agents for others in negotiating contracts, purchases, or sales. Brokers may act as intermediaries between any buyer or seller of scrap metal. The broker is different from the peddler because the broker may not take physical possession of the scrap.

Major Issues

Purchases

Although not present in every case, a major issue found in many examinations of purchasers was inadequate substantiation of purchases. Taxpayers supported their scrap purchases in a variety of ways. Substantiation varied from very detailed records to no records at all. Some taxpayers kept precise records for some sellers and no records for other sellers. Cash slip/weight tickets were sometimes incomplete, illegible, or prepared with false names. A disallowance of an offset for cost of goods sold may be warranted if the taxpayer does not provide adequate substantiation to verify purchases. In most cases, verification of a purchase may be made when sellers are paid by check because the sellers can be identified by the endorsement on the check. However, there are instances where checks are issued and the ultimate seller cannot be identified, such as when checks are issued in fictitious names and cashed for the seller by an employee of the purchaser.

Treas. Reg. section 1.61-3(a) states that:

in a manufacturing, merchandising, or mining business, 'gross income' means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources.

Treas. Reg. section 1.162-3 states that:

taxpayers carrying materials and supplies on hand should include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operation during the taxable year for which the return is made. . . .

Thus, the regulations allow the taxpayer an offset against sales for purchases made and consumed during the tax year.

Substantiation for scrap metal purchases is an important issue. It was addressed in *Bard v. Commissioner*, T.C. Memo. 1990-431. In *Bard*, the court stated that the taxpayer has the burden of proving the costs of goods sold and that the question of substantiating the amount is a factual one. Because of the vast extent of cash dealings and the taxpayer's fragmented and incomplete records and documentation, the court found that the taxpayer did not meet his burden of proof. The court upheld the Service's disallowance of part of the taxpayer's claimed cost of goods sold. As the *Bard* case demonstrates, the taxpayer will not always be allowed an offsetting cost of goods sold deduction for amounts that they have included in total sales when they cannot substantiate the purchases.

In the recent decision, *Bobry v. Commissioner*, T.C. Memo. 1997-27, the taxpayer submitted receipts showing unit cost, total cost, metal type, and weight of scrap metal received as

substantiation for cash purchases. However, the taxpayer did not record the names of the sellers. Without that information, the Service was unable to conduct third party contact to verify the transactions. Accordingly, the Service disallowed 83 percent of the taxpayer's cash purchases. In his opinion, the judge pointed out that taxpayers generally bear the burden of proof regarding the proper amount of costs of goods sold, and they are expected to maintain adequate records to substantiate their deductions. However, the judge also acknowledged that taxpayers are entitled to offset gross revenue with cost of goods sold. The judge cited *Cohan v. Commissioner*, 39 F.2d 540, 544 (2d cir. 1930) and held that the taxpayer was entitled to include 95 percent of its calculation of cash scrap purchases. In *Cohan* it was held that where taxpayers do not have adequate records, but where the record suggests that they clearly incurred an offset to gross income, courts may estimate the offset based on the evidence.

While the Service believes that the petitioner's deductions in *Bobry* should have been more severely limited, the opinion does support the proposition that a taxpayer with inadequate records will be disadvantaged. In the opinion, the judge was critical of the petitioner's record-keeping methods and denied five percent, which is still a considerable amount, of the petitioner's deductions because of inadequate records. Moreover, he sustained the imposition of the accuracy-related penalty because the petitioner failed to maintain complete records.

Although the above decisions addressed the substantiation issue, adequate substantiation is to be determined by the merits and facts of each case. Moreover, examiners should keep in mind that in the wholesale and retail industries when gross revenue is generated, a corresponding cost of goods sold generally exists. However, if the taxpayer is unable to specifically show the incurrence of the cost associated with the specific revenue reported, and the taxpayer does not provide adequate corroborating evidence to support the accuracy of the claimed deduction, then the cost of goods sold issue should be raised. Assistance should be requested from District Counsel in determining the merits of specific cases. Consideration should be given to the issuance of an Inadequate Records Notice when circumstances warrant it.

Note: As is possible in any other type of business, income from the scrap metal business may be diverted to the owner of the business. This diversion may occur through the overstatement of purchases. The income reported on the shareholder's returns should be reviewed in light of the shareholder's standard of living to determine if the amount deducted for purchases that cannot be substantiated may have been diverted for the shareholder's personal use. Consideration should be given to whether the amount of unsubstantiated purchases should be included in the shareholder's income. The owner may also divert income by having the business report less income than received and withdrawing the unreported cash from the business. An indirect method on the shareholder may be appropriate if there is a reasonable indication of unreported income.

Pre-Audit Steps

The pre-audit plan for the purchaser of scrap metal would include any and all items that you would consider for any examination, but specific consideration should be given to the items listed below:

1. Research the Currency and Banking Retrieval System (CBRS) to determine if any Forms 4789, *Currency Transaction Reports*, or Forms 8300, *Report of Cash Payments Received by a Trade or Business*, were filed with the Internal Revenue Service (IRS) by or on behalf of the taxpayer. Filings of either form indicate that the purchaser is dealing in cash.
2. In the initial contact with the taxpayer, request an interview with the individual most familiar with the day-to-day operations of the business. If this individual is not the owner of the business, also request that the owner be present. This is essential because the specific interview questions that follow should be addressed to the person who is most familiar with the business operations, usually the owner of the business. The responses to the interview questions will help determine the scope of the examination, and thus, the interview should be conducted at the early stages of the examination.
3. In the initial contact with the taxpayer, arrangements should be made to tour the business and to conduct the examination at the business site. Many observations made during the tour and the on-site examination may aid you in your examination. For example, the types of scrap containers used by the taxpayer may indicate the existence of industrial accounts. Also, the names on trucks entering and exiting the processor's location may help to identify the taxpayer's customers.

Information Document Request

In addition to the general request for items for the initial appointment, the following items should also be requested:

1. Weight tickets for cash purchases;
2. Cash slips (may include weight and price) for cash purchases;
3. Copies of shippers prepared by the seller for cash purchases;
4. Metal settlement reports or summary statements;
5. Reconciliations of daily cash balances with the amounts used to purchase scrap;
6. Copies of all checks that were written to cash;
7. Listing of all names and addresses of your suppliers of scrap metal;
8. Schedule of advances made to suppliers; and
9. Contracts or bids given or received for large jobs, such as contracts for dismantling plants, water towers, or bridges, etc.

Note: Items one through four are defined in the glossary.

These items will generally be the same items that the taxpayer will use to document purchases. The taxpayer may not maintain all these records or may refer to them by different terms. Therefore, they should be discussed with the taxpayer so that all documentation that the taxpayer uses to substantiate cash purchases is obtained.

Interview Questions

The interview questions and comments that follow relate to the taxpayer's purchases of scrap metal and should be incorporated into the agent's general interview questions. The responses to the general interview questions should provide an in-depth knowledge of the taxpayer's business operations. The taxpayer's responses to the questions might require further inquiries into some areas. The agent will have to use good judgment in expanding the line of questioning when warranted.

What types of metals do you purchase?

Find out if the taxpayer purchases ferrous and/or nonferrous metals. If the taxpayer purchases nonferrous metals, which types of nonferrous metals are purchased?

Approximately what percentage of your purchases are from each type of metal?

This will give you a general idea of the overall makeup of the taxpayer's purchases.

In what condition do you accept the scrap metal?

Determine how particular the taxpayer is regarding the condition of the scrap. For instance, the taxpayer may accept contaminated scrap. Scrap can be contaminated by other types of metals, machining oil, or any other types of debris. The taxpayer will pay less for contaminated scrap.

What type of processing do you perform before the scrap metal is sold?

Processing includes, but is not limited to, upgrading, sorting, cutting, and cleaning the scrap. The amount of processing that the taxpayer has to perform will affect his cost of goods sold deduction.

How do you determine the price that you pay for your scrap metal?

The taxpayer may call the foundry or mill to find out what they are currently paying for the scrap, or he may consult *New Steel* (formerly *Iron Age*) magazine for ferrous scrap prices or *American Metal Market* newspaper for ferrous and nonferrous metal prices. The taxpayer may then use this information in a formula to determine a purchase price that will generate a profit for him. Find out the formula. As a point of information, the prices of nonferrous metals fluctuate more than ferrous metals.

What types of accounts do you handle?

Industrial, peddlers, brokers, or others? Determine from whom the taxpayer purchases scrap metal and the type of metals purchased from each account.

Who handles the accounts?

If applicable, determine which individuals enter into bids or contracts or handle specific accounts.

What percentage of your purchases is made from each type of account?

Determine the amount of purchases made from each type of account.

Who are the primary suppliers in each type of account?

Determine what businesses or individuals supply the scrap for each type of account. The agent should consider the responses from the two preceding questions to determine the depth of information to be obtained through this question.

Describe the process that takes place when someone arrives at your place of business with scrap metal to sell.

This description should detail items such as the name of person who operates the scale; how the scale operates whether a person can manually adjust pounds on weight tickets or whether the scale provides a printout; name of person who prepares the weight ticket; a list of other documentation that is prepared, if any, name of person who actually makes the payout from the documentation provided; and when the payout is made.

Describe the process that takes place when you pick up scrap metal that you are purchasing.

Determine if the taxpayer keeps containers at the seller's place of business. How often does the taxpayer empty the containers for the seller? Also ask how many trucks the taxpayer has to pick up scrap metal. Find out who the drivers of the trucks are. You may also want to find out if the drivers are treated as employees. If they are not, you may want to consider if the drivers should be treated as employees. What type of documentation is provided to the seller when the scrap metal is picked up? Where is the scrap weighed? What other documentation is prepared? When and how is the actual payout made?

What percentage of your purchases is paid in cash, and what percentage is paid for by check?

In response to the two descriptions above, the taxpayer will generally state that some purchases are paid for with cash. This question begins the line of questioning regarding cash purchases.

How do you obtain the cash used for purchases?

Are checks written to cash?

From what bank account(s) do you withdraw the cash?

Who withdraws the cash from the bank? How often?

What records do you keep to reconcile the cash amounts withdrawn to the amounts that are spent on cash purchases?

What person(s) performs the reconciliation? Is there an actual count of the cash? Who performs the count?

What internal controls do you have in place to ensure that cash is not diverted?

Did your accountant or financial advisor impose any controls to ensure that cash is not diverted?

How much cash do you have on hand for scrap purchases during a normal business day?

Where is the cash kept?

Do you pay the same price per pound for metals regardless of whether or not the payment is to be made in cash or by check?

Determine if there is an incentive for the buyer to pay out either type of payment.

How do you determine whether the purchase will be paid for in cash or by check?

Determine who makes the decision whether the payments are to be made in cash or by check. Why has the seller requested cash? Why is the buyer paying in cash? Does the dollar amount of the sale make any difference? Are there any special arrangements in place with certain types of sellers concerning payment policies?

Do certain sellers receive payments for a load of scrap both in cash and by check?

If they do, find out the reason why this would be necessary.

What identification is required before cash is paid out to the seller?

What information or identification does the taxpayer require from sellers? Find out if the taxpayer requires any of the following: name, name of business that the driver is transporting the scrap for, address, driver's license number, license plate number, social security number, Department of Public Safety identification card number, military identification card number, passport number, or a United States Immigration and Naturalization Service work authorization (green card) number. Who writes the information down, the seller or the purchaser? Is the information verified in any way?

What documentation is provided to the seller to document the payment of cash for the sale of the scrap metal?

Make sure to determine if different types of documentation are provided to different types of sellers. Even though you have already requested a description of the paperwork process when scrap is purchased in prior questions, make sure you can trace through a typical transaction. For example, does the taxpayer prepare weight tickets, cash slips, metal settlement reports, summary sheets invoices, and/or purchase journals, etc.?

Do you retain the documentation discussed above?

Determine what documentation the taxpayer has retained. If the taxpayer has not retained the documentation, find out why. Also, if the taxpayer has not retained the documentation, you may want to discuss ways to reconstruct the documentation at this time.

How does the company account for purchases made by check?

Is the procedure the same as for purchases paid for in cash? If not, explain the differences.

Who signs the checks?

What documentation is provided to the person who signs the check?

Are checks written to cash and then cashed by the taxpayer for the seller?

Why does the taxpayer provide this service to the supplier?

Are checks written to the payee and then cashed by the taxpayer for the payee?

Why does the taxpayer provide this service to the supplier?

Are any purchases made from outside the United States?

Find out how the payment is made. Consider contacting an international examiner for assistance.

Development Process

As with any other industry, record-keeping practices will vary from taxpayer to taxpayer. Some taxpayers may maintain very complete records and others will not. Nonetheless, agents should be aware that substantiating documentation for scrap purchases may be deficient for any number of reasons. The examples that follow describe some particularly abusive situations in which scrap processors failed to substantiate purchases.

Examples

1. **Use of Fictitious Names.** Cash slips/weight tickets may be prepared using fictitious names so that the agent will be unsuccessful in following the audit trail. The scrap processor may not request proper identification from the seller because there is no concern about leaving an audit trail, or, the processor may be aiding the seller in underreporting income. The scrap processor may be preparing fictitious invoices to inflate purchases and take a larger deduction for purchases while funds are diverted for personal use or for a “related” party. A properly prepared cash slip/weight ticket would include an authentic name, date, weight and description of material, dollar amount paid for material, and a signature. Larger scrap processors may also use pre-numbered cash slips/weight tickets for internal control purposes.

Sampling of the scrap processor’s documentation for cash purchases will provide an indication of the type of substantiation prepared and kept by the taxpayer for cash purchases. If you find questionably prepared documentation, analyze it to determine what identifying information can be obtained from it to locate the seller. Also inquire as to whether the taxpayer maintains any other data on the seller that may show the seller’s complete name, address, phone number, corporate or business name, license number, or plate number, etc. Consider expanding the scope of the examination for purchases. Also question the taxpayer thoroughly regarding the questionably prepared documentation. Many times the taxpayer will be quite familiar with his steady customers and will be able to identify certain sellers who receive cash payments. It is important for the purchasers to provide the necessary information so examiners will be able to conduct third-party contact with the sellers to verify the purchases.

In cases where the processor has not kept adequate records and it appears that the processor may have used fictitious invoices to divert funds for personal use, consider examining the person who may have received the funds. If a reasonable indication of unreported income exists, an indirect method of determining income should be performed as part of the examination of the person.

2. **Use of Two Different Payees.** Taxpayers may list the correct seller of the scrap metal in the check register and then write the check out to “cash” or to someone

other than the person or entity that sold the scrap metal. The scrap processor may be attempting to shield the seller by not preparing the check in the name of the seller.

The examiner should take a random sample of purchases paid for by check and match the payee names in the check register with the names provided on the invoices and the cancelled checks. If the payee in the check register is not the same as the one on the invoice or the cancelled check, investigate further to determine the true recipient of the income.

- 3. Falsified Documents Used in Light-Weighing Scrap.** A taxpayer may alter the dollar amounts or alter weight amounts on the cash slip/weight tickets. The scale operator may alter the dollar amount on the cash slip/weight ticket after the customer receives a copy of the ticket and has been paid for the scrap metal. Another method used by scrap processors may be to “light” weigh the scrap. This is done by adjusting the scale or having the customer not put all of his truck wheels across the scale. The customer then receives an invoice for the light weighed scrap. Later the scrap processor prepares another invoice that shows the correct weight of the scrap and the proper amount that should have been paid out. Unless the customer has previously weighed the scrap or senses that his load of scrap weighs more than the scrap processor has calculated, the customer will not realize that his scrap has been “light” weighed. By altering the dollar amount or the weight amount on the cash slips/weight tickets, the taxpayer inflates his purchase deduction and can possibly divert funds to himself or another “related” party.

This impropriety is usually discovered when the seller of scrap metal is presented with documentation regarding his scrap sales. The seller can dispute the cash slip/weight ticket by presenting his copy of the cash slip/weight ticket that shows the amount he was paid. Thus, it is important that the processors record the names and locations of the sellers. Without that information, the Service would be unable to conduct third-party contacts with the sellers to verify the accuracy of their claimed deductions. Also, if the cash slip/weight ticket is numbered, third-party contacts may aid you in determining that the ticket has been altered.

If it appears that funds have been diverted for personal use or for the use of a related party by falsifying cash slips/weight tickets and a reasonable indication of unreported income exists, an indirect method may be appropriate as part of the examination of the person who appears to have received the funds.

In all of these instances, it may be necessary to interview the persons questioned during the initial interview again and conduct interviews with employees of the taxpayer in order to obtain all the facts for each particular case.

Purchases in Cash

If the taxpayer does not keep adequate documentation to substantiate cash purchases and it appears that sampling will not identify all “questionable” transactions, consider compiling the documentation on a database. If the taxpayer will not provide the documentation, consider issuing a summons. Copy the documentation if the taxpayer requests that it be returned quickly or if it will be needed for later examinations. Each payment made by the taxpayer for cash purchases should be inputted to the database. It is important to identify the fields that you wish to include in the database before inputting the data. Each piece of documentation may include different information for different sellers, therefore the database should be able to capture for many different types of identifying information. Appropriate fields include, but are not limited to, first name, last name, business name, address, city, state, date, amount, driver’s license number, plate number, invoice number, ticket number, name of agent who worked the case, the name of the taxpayers who paid out the amounts, and miscellaneous. The miscellaneous field can be used for unusual items.

After the data is inputted, the database can be sorted and stratified so the data can be analyzed to determine if the taxpayer has substantiated the purchases. If the sellers cannot be identified, determine if there are other ways to identify them. It is important to identify the sellers so they can be contacted to verify the accuracy of the transactions. Consideration should be given to picking the returns of the sellers, when appropriate, to determine if they reported the income. The use of affidavits should be considered when discrepancies arise. Employees of the scrap processor may attest to the fact that the payee did receive the cash payment. “Whipsaw” treatment should be considered if it is impossible to determine which party is responsible for the discrepancy.

Purchases by Check

Purchases recorded in the check register should be compared to the purchase journal and the cancelled checks. Determine if shareholders appear to be receiving corporate payments. Consideration should be given to examining the shareholder's returns to ensure the income is being reported.

A good examination technique is to review the endorsements on the checks used to purchase scrap metal. The following situations may exist:

1. The check may be made payable to a corporation and endorsed by the corporate officer but not deposited into the corporate bank account. It may be deposited into a personal account or cashed at the bank with no funds being deposited into the business account.
2. A business may sell the scrap it generates, but the check may be written to an individual rather than the business. Thus, the funds are never deposited into a

business account. The check proceeds are either kept by the payee or deposited into a personal bank account.

3. The scrap processor or purchaser may cash the check for the seller after the seller endorses the check. The check may be written in the seller's name or in a fictitious name. The proceeds usually will not be deposited into the business account because the payee keeps the cash or deposits the cash into a personal account.

Sellers of Scrap Metal

Types of Cases

There is no limit to the types of businesses that may sell scrap metal. Listed below are some of the more common business operations. They are establishments engaged in:

1. Fabricating ferrous and nonferrous metal products, such as metal cans, tinware, hand tools, cutlery, general hardware, nonelectrical heating apparatus, fabricated structural metal products, metal forgings, metal stamping, ordnance, and a variety of metal and wire products;
2. Manufacturing metal bolts, nuts, screws, rivets, washers, formed and threaded wire goods, and special industrial fasteners;
3. Manufacturing iron and steel forgings or nonferrous forgings;
4. Manufacturing automotive stampings, such as body parts, hubs, and trim;
5. Manufacturing metal crowns and closures;
6. Manufacturing metal stampings and spun products, including porcelain and enameled products. Products may also include household appliance housings and parts;
7. Manufacturing, on a job basis, special tools and fixtures for use with machine tools, hammers, die-casting machines, and presses (commonly known as tool and die shops);
8. Cutting, slitting grinding, polishing, or sanding metal;
9. Demolishing buildings and selling scrap metal from the destroyed building;
10. Selling used auto parts, such as alternators and transmissions;
11. Purchasing and selling scrap metal; for example, peddlers and brokers; and
12. Conducting any type of business activity where the obsoleted equipment or buildings may be sold as scrap metal.

Major Issues

Unreported Income

Internal Revenue Code (IRC) section 61 defines gross income means as all income from whatever source derived. Thus, sellers of scrap metal must include the amount of the payments received from the sale of scrap metal, after adjustment for cost of goods sold, in gross income. See Treas. Reg. section 1.61-3(a).

Assignment of Income

A much more difficult question involves the determination of who is the proper recipient of the income for tax purposes. The basic legal principle to be applied here is that income is taxable to the person who earns it. Court cases that deal with this issue include *Lucas v. Earl* 281 U.S. 111 (1930) and *Home Juice Co. v. Commissioner* T.C. Memo. 1977-386, aff'd without opinion, 601 F.2d 599 (7th Cir. 1979). While the principle is easy to state, it is difficult to apply where an individual who is also an officer and/or shareholder of a corporate recipient purports to sell scrap metal in his or her individual capacity, rather than as an agent of the corporation. The income is taxed to the corporation if, based on a careful consideration of the facts and circumstances, the individual was acting as an agent of the corporation with regard to the sale. See *Home Juice Co. v. Commissioner*.

Unreasonable Compensation and Constructive Dividends

Assuming income derived from a corporate officer/shareholder's sale of scrap metal is taxed to the corporation, the corporation will likely argue that it is entitled to an offsetting deduction for officer compensation. In other words, even though the resulting cash receipt would otherwise bypass the corporate books, income to the corporation, followed by a corporate payment to the officer, can be imputed. The issue then becomes whether this imputed corporate payment represents compensation to the individual in his capacity as an officer or a possible constructive dividend to the individual in his capacity as a shareholder. The classification of a payment as compensation or as a constructive dividend depends on the purpose for which the payment was made. Treas. Reg. section 1.162-7(a) states: "[T]he test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. . . ." See *Common Industry Issues-Unreasonable Compensation* for factors to consider in making this determination.

A distribution to a shareholder with respect to his/her stock is subject to IRC section 301 and is treated as a dividend to the extent of the corporation's earnings and profits even if not formally declared. In the scrap metal industry, constructive or disguised dividends may arise from the shareholder's personal use of business property.

For example, a shareholder may make sales of business-owned scrap metal for the shareholder's own account. Alternatively, consideration received from business sales of scrap metal may go partially to the corporation by check and partially to the shareholder in cash. In both cases, the shareholder is personally deriving an economic benefit from the use of business property and may be receiving a disguised dividend. The shareholder may argue in response that the cash is actually a loan. See *Common Industry Issues-Loans to Shareholders* for factors to consider in making this determination.

The economic benefit from these sales might also be treated as additional compensation to the shareholder if he/she is also an employee. There are several factors to consider in determining whether personal use of property amounts to a dividend or compensation: corporate ownership of the property sold, existence of corporate obligations to the shareholder for services rendered and the actions of the parties regarding the obligations, the reasonableness of the amounts paid to the shareholder as compensation, and the treatment of the distribution on the books of the corporation. See *Bard v. Commissioner*, T.C. Memo. 1990-431, which held that corporate officers received compensation when selling scrap metal, and *Joseph H. O'Brien v. Commissioner*, T.C. Memo. 1978-185, which held that constructive dividends were received when corporate officers diverted corporate funds to private accounts.

Pre-Audit Steps

Keep in mind that cases can be assigned to an agent based upon information obtained from purchasers, or because the taxpayer is in the business of selling scrap metal or generates scrap metal through business operations. **The items mentioned below relate mainly to situations in which information has been obtained through purchasers prior to the examination of the seller.** Obviously, if you do not have information regarding the taxpayer's scrap sales, not all of the pre-audit items will be applicable.

The pre-audit plan for sellers of scrap metal would include any and all items that you would consider for any examination, but specific consideration should be given to the items listed below:

1. The documentation that was obtained from the purchaser that relates to your taxpayer should be analyzed and evaluated. The documentation may consist of, but is not limited to, weight tickets, cash slips, shippers, invoices, cancelled checks, and metal settlement reports. Determine if the documentation shows that a pattern of payments exists that would establish how often and in what quantity the taxpayer sells the scrap metal. If the taxpayer is a corporation or a partnership, determine if payments are made to the entity, the shareholder(s) or the partners, or the employee(s) of the entity. If it appears that a partner(s) or shareholder(s) may be receiving payments that may be income of the partnership or corporation, respectively, consider obtaining RTVUE's to determine if the income is reported on their individual tax returns. This will also give you a general idea of the amount of income that is reported on the returns. As the case progresses, you will be able to determine if the income reported on the return(s) is commensurate with the individual's standard of living.
2. Review the tax return to determine if the scrap income is reported separately on the tax return. The scrap sales will generally appear on the other income line of *Schedule C* or the other income line on Forms 1120, 1120S, or 1065. If the income is separately stated, determine if it reconciles to the amount that you show as being received by the recipient from the scrap processor. Keep in mind that even if the amount reconciles, the taxpayer may have received amounts from other scrap processors, so you may still need to examine the return.
3. Utilize the CBRS to determine if any Forms 8300 or 4789 were filed by or on behalf of the taxpayer. If you are examining a corporation or partnership, requests for CBRS searches should be made for the corporation and partnership along with the respective shareholder(s) or partners. Through the request, you may obtain information regarding the taxpayer's transactions of cash in excess of \$10,000. The absence of any filings should not be accepted as conclusive proof that the taxpayer did not receive cash because the taxpayer may have received amounts below the \$10,000 reporting requirement.

4. In the initial contact with the taxpayer, firmly request that the individual most familiar with the day-to-day operations of the business be present. If this individual is not the owner of the business, also request that the owner be present. This is essential because the specific interview questions that follow should be addressed to the person who is most familiar with the business operations, usually the owner of the business. The responses to the interview questions will help determine the scope of the examination, and thus, the interview should be conducted at the early stages of the examination. Also, it may be necessary during the examination to have subsequent interviews with the owner and/or other employees of the taxpayer.

5. In the initial contact with the taxpayer, arrangements should be made to tour the business and to conduct the examination at the business site. Many observations made during the tour and the on-site examination will aid you in your examination. For example, notice the type(s) and number of containers that the taxpayer keeps on the premises to hold scrap metal. A greater number of containers may mean more scrap is generated. Grinding, sanding, and polishing operations usually produce less scrap than cutting operations. In cutting operations, heat is produced. Deeper cuts require more heat and thus would generate more scrap metal. You may need to seek advice from an engineer if you are not familiar with certain manufacturing operations in order to determine the extent of scrap metal generated. Clean plants generally mean good controls. This type of plant may have better production controls, and therefore, less scrap metal may be generated. Ask any follow-up questions that will aid you in understanding the taxpayer's business operations and the type and extent of scrap metal generated from the manufacturing processes.

Information Document Request

In addition to the general request of items for the initial appointment, the following items should also be requested:

1. Weight tickets for scrap sales;
2. Shipping documents for scrap sales;
3. Invoices prepared for scrap sales;
4. Receipts received for scrap sales;
5. Cash slips for scrap sales;
6. Metal settlement reports for scrap sales;
7. List of names and addresses for businesses that purchase the taxpayer's scrap metal;
8. Any internal documentation kept to record the amount and type of scrap metal generated by the manufacturing operations; and
9. Contracts or bids given or received for large jobs, such as contracts for dismantling plants, water towers, or bridges, etc.

Note: Items one, two, five, and six are defined in the glossary.

The items listed are the items that the taxpayer generally will provide to you to document sales. The taxpayer may not maintain all the records or may not use the same names for the documents. Therefore, discuss the items requested with the taxpayer so that everything he/she uses to document scrap sales is obtained.

Interview Questions

As mentioned in the beginning of this section, sellers of scrap metal can be involved in any number of different types of business operations. The following are some sample interview questions that examiners should consider asking in addition to the usual general interview questions. It is assumed that the responses received from the general interview questions have provided an in-depth knowledge regarding the taxpayer's business operations and the type of scrap metal that is generated. Also, the agent should question the taxpayer about significant amounts of cash that may exist at the beginning of the taxable period at issue. The taxpayer's responses to the questions might require further inquiries into some areas. The agent will have to use good judgment in expanding the line of questioning. As with all interviews, an attempt should be made to obtain responses for the questions during the first interview with the taxpayer.

What internal controls do you have regarding the quantity of scrap metal generated by your business operations?

The answer to this question should reveal if the taxpayer keeps an audit trail for the scrap metal. As a job progresses, does the taxpayer allow for a certain amount of scrap? What are the taxpayer's tolerances for manufacturing errors? A lower tolerance will account for a larger amount of scrap because the taxpayer will probably scrap more defective items.

What records do you maintain regarding the quantity of scrap metal generated by your business operations?

See if the taxpayer still has the records available. These records can be used to determine if all the scrap sold is properly reported in income.

Whose responsibility is it to monitor the amount of scrap metal that results from your business operations?

Obtain the names of everyone who is involved with monitoring and handling the scrap metal. This should include employees as well as outside and/or contract labor. These persons may be interviewed later in the examination if necessary.

Describe the process that takes place after scrap metal is generated until the time it is sold.

A description of the process would include the handling of the scrap from the time it is generated until it is received by the purchaser.

Is the scrap combined with different materials or kept separate?

A taxpayer that has very little scrap may combine the scrap with other refuse and have to pay to have it taken away or may receive a lower price for it. Keep in mind that a taxpayer that claims

he does not sell his scrap metal is, most likely, paying to have the scrap hauled away. The taxpayers books and records should reflect payments made to haul the refuse away.

What types of containers do you place the scrap metal in?

Determine the size of containers that the taxpayer has so as to be able to approximate the amount of scrap generated.

How many containers do you use?

Who owns the containers?

During a tour of the business, determine if the containers that are not owned by the taxpayer are owned by the scrap processor.

How often are the containers emptied?

Determine if the processor has a regular pick up schedule or if the taxpayer calls the scrap processor for a pick up.

Who decides when the containers will be emptied?

Determine who arranges for the pick up of the scrap metal.

To whom do you sell the scrap metal?

Request the taxpayer to provide the names of all purchasers to whom the scrap is sold.

What type of records are created for the sale of scrap metal?

Does the taxpayer prepare a shipper when the scrap is removed from the business premises?

Do you weigh the scrap at your business premises?

Determine if the taxpayer has a weight scale.

What types of records were received from the purchaser for the sale of the scrap metal?

Did the taxpayer receive weight tickets, cash slips, shipping documents, invoices, receipts, metal settlement reports, or any other type of documentation when the scrap was sold?

Who receives the records?

Do you have the records?

If a taxpayer did not maintain records, find out why not.

How do you account for the scrap metal in your books and records?

Do you credit your purchases account or is the amount included in gross receipts or other income? How do you include the amount in income--cash or accrual method?

Who records the scrap metal transactions in the books and records?

Bookkeeper, controller, or other employee?

How often are the transactions recorded?

Do you receive cash and/or checks for the payment of scrap metal?

If you receive payment by check, to whom is the check made out?

If the check is not made out to the business, who is it made out to? Why? What happens to the funds if the check is made out to someone other than the business?

Who takes possession of the check?

If applicable, to whom is it forwarded?

Who prepares the deposit slip?

Who deposits the check into the bank account?

If the check is not deposited in a business account and is cashed, what happens to the cash?

Determine if the funds are used for a business purpose. Does the taxpayer have documentation to show the business use?

Into what bank account is the check deposited?

If the payments are made in cash, who receives the cash?

Where is the cash deposited? If the cash is not deposited, what happens to it?

Determine if the funds are used for a business purposes. Does the taxpayer have documentation to show the business use?

Who prepares the deposit slip?

Who deposits the cash into the bank account?

Which bank account is the cash deposited?

Why does the taxpayer receive cash instead of a check?

Determine if the decision to pay by cash was made by the seller or the purchaser.

What internal controls does the taxpayer have in place to ensure that scrap income is not diverted?

Development Process

The examples that follow describe situations where the income from the sale of scrap is underreported. Like any other type of examination, each examination on scrap sellers should be developed based on the facts and circumstances of the individual case. However, the following examples are being provided to show how the issue can be developed.

Situation 1:

A scrap processor purchased aluminum scrap from the taxpayer, a machine shop. The taxpayer filed tax returns as a corporation. The taxpayer sold some scrap and was paid for part of the sale with a check. The remainder was paid in cash. The check was reported in the taxpayer's income, but the cash was not. The taxpayer's shareholders stated that they took the cash for their personal use.

The agent noted that the taxpayer also purchased copper. The copper was purchased for use in the taxpayer's machining process. After the copper was processed, the remaining scrap was sold. No income from the sale of the copper scrap was reported in the taxpayer's books and records. The shareholders provided the following information regarding the discrepancy:

- a. The shareholders personally delivered the copper scrap to the processor, who was not the same processor that was sold the aluminum scrap.
- b. The shareholders sold the scrap under a fictitious name.
- c. The shareholders endorsed the check and gave it back to the scrap processor. The processor took the check to the bank and cashed it and then gave the cash to the shareholders.

Substantive Tax Issues:

- a. The corporation (machine shop) has the following sources of unreported income:
 1. Cash proceeds from sale of aluminum scrap, and
 2. Sales proceeds from sale of copper.
- b. The cash proceeds from the aluminum sales and the sales proceeds from copper went to the shareholders and, therefore, are taxable distributions to them.

Situation 2:

The agent noted that cash payments for scrap purchases made by a scrap processor were being made to various corporations with the same vehicle license plate number. The agent was able to determine the name of the corporation that was generating the scrap metal and the shareholder's name through the vehicle license plate number. While interviewing the scrap processor, it was discovered that the shareholder wrote with his less dominant hand to place the fictitious corporate names on the cash slips/weight tickets. The employees of the scrap processor positively identified the shareholder as the person who received the cash payments on the fictitious cash slips/weight tickets. The income received on behalf of the fictitious corporations was not reported by the corporation nor by the shareholder who took possession of the cash.

Substantive Tax Issues:

- a. The seller corporation underreported income from the transactions entered into using the fictitious names.
- b. Since the proceeds went to the shareholder personally, the unreported income is also a taxable distribution to the shareholder.

Situation 3:

During an examination of a scrap processor, the agent noted that the payment made to a scrap peddler by the scrap processor for each load of scrap was made either in cash or with two checks. The peddler requested the method of payment. The peddler calculated gross income by totaling up the deposits made into his checking account. The peddler did not report all his cash receipts in gross income. In addition, when payments for a single load of scrap were made with two checks, the first check would be cashed, but the proceeds would not be deposited into the business checking account. Sometimes, the second check was totally deposited and reported as income. Other times, the peddler would deposit only part of the second check. As a result, only the net deposit was included in income.

Substantive Tax Issue:

The peddler failed to report all cash income and reported only a portion of the income paid by checks since only the portion deposited was reported.

Situation 4:

The agent noted that a peddler was receiving cash advances from the scrap processor for future sales of scrap metal. The amount of cash that the peddler received when the scrap was delivered was reduced by the amount of advances that he had received. The agent found that the peddler only reported as the net income amount received when the scrap was delivered in income and did

not report the amount of cash that was previously advanced to him. The peddler acknowledged his failure to report all income.

Substantive Tax Issue:

The peddler did not report the advances received prior to delivery of the scrap as income.

Situation 5:

It was discovered in the examination of a scrap processor that a metal processing corporation was paid both by cash and check for scrap. This corporation would generate a considerable amount of scrap metal in its everyday operations. It was also determined that this company deposited all checks in the corporate account and reported those amounts as income. However, the cash payments were not deposited and not reported. The cash was kept by the owner and used for personal expenses.

The metal processing company became aware that the IRS was looking at cash payments for the sale of scrap. Upon learning of this, the corporation filed amended corporate tax returns reporting the cash payments as income. At the same time an expense equalling the amount of cash payments received was deducted as “additional officer’s salary.” The amended returns were filed by the taxpayer prior to the beginning of the examination.

Substantive Tax Issue:

The deduction for “additional officer's salary” on the amended return should be questioned. The issue is whether the amount represents compensation for services actually rendered. If so, why was the amount not previously reflected on the corporate or the shareholder's returns?

Situation 6:

A metal processing corporation was receiving payments in cash and by check for scrap sales. A considerable amount of scrap metal is generated in this type of operation. All checks were deposited into the corporate account and reported as income. However, the cash payments were not deposited and not reported. The president of the company claimed that the cash was used to purchase corporate assets. However, no purchases of corporate assets were found. Instead, a review of invoices uncovered personal items being paid for by the corporation.

Substantive Tax Issues:

- a. The corporation failed to report income from cash sales of scrap.

- b. Taxable distributions to the shareholder for the personal items were paid for by the corporation.

Situation 7:

While reviewing the check register of Company A, a scrap processor, the agent noticed that a substantial amount of checks were written to Company B for scrap purchases. The following information was discovered regarding the purchases:

- a. Company B was owned by a shareholder of Company A.
- b. Company A was light weighing scrap that it purchased from suppliers. This generated excess scrap that had to be accounted for on the books and records of Company A.
- c. Fictitious purchase and sales invoices were prepared by Company A and B, respectively, to give the impression that Company B was actually selling scrap metal to Company A.
- d. Company B was not actually selling scrap to Company A. Company B was set up as shell corporation to funnel cash from Company A to B. Checks written by Company B for purchases were written to cash, and the cash was received by the shareholder of Company B.

Substantive Tax Issues:

- a. The fictitious “purchases” deduction from Company B should be disallowed to Company A. The amount of scrap underweighed should be included in Company A’s inventory but given a zero basis.
- b. The cash received by the shareholder should be considered as a taxable distribution from Company B.

Note: In some cases, it may be advisable to consider the assertion of the accuracy-related or fraud penalties. Of course, the assertion of either penalty should be based on the facts and circumstances of each individual case. Agents are encouraged to contact their local District Counsel Office to discuss various factual circumstances. In particularly egregious cases, referral should be made to the Criminal Investigation Division (CID).

This page intentionally left blank.

Chapter 3

Common Industry Issues

The following section discusses some of the most commonly found issues in the examinations that were performed. These issues may be present in examinations of purchasers or sellers. While not all issues will be present in every examination, this summary may help you in your pre-audits.

Accumulated Earnings

IRC section 531 imposes a tax on corporations that retain earnings and profits instead of distributing them. Corporations can retain earnings and profits for the reasonable needs of the business. Treas. Reg. section 1.537-2(b) lists several reasonable needs, which include:

1. Bona fide expansion of business or replacement of plant;
2. Acquisition of a business enterprise through purchasing stock or assets;
3. Retirement of business debt created in connection with the trade or business;
4. Working capital. (A corporation is entitled to accumulate capital necessary to finance operations during its typical operating cycle.);
5. Investments or loans to suppliers or customers if necessary to maintain the taxpayer's business; and
6. Reasonable reserves for contingencies.

Unreasonable accumulations of earning and profits as listed in Treas. Reg. section 1.537-2(c) may be indicated by loans to shareholders, their family members, and other businesses under shareholder control that are not in the business of the taxpayer corporation; investments in properties or securities unrelated to the business activities of the taxpayer corporation; and retention of earnings and profits to provide against unrealistic hazards.

The tax is computed on accumulated taxable income, which is the corporation's taxable income with certain adjustments. The tax rate is currently 39.6 percent.

Built-In Gains--S Corporations

IRC section 1374 provides that corporations electing S corporation status after 1986 are subject to a tax imposed on any net recognized built-in gain during the ten-year period, beginning with the first day the corporation is an S corporation. Generally, built-in gain is the amount by which the fair market value of a corporate asset exceeds its adjusted basis on the first day of S corporation status. The corporation may use C corporation tax attributes to reduce tax liability, subject to limitations. The tax rate is the highest corporate tax rate imposed by section 11(b).

Relief is allowed to certain small corporations making S elections after 1986 but before 1989. Relief is phased out for qualifying corporations whose assets are valued from \$5 million to \$10 million. The qualifying corporation is subject to the prior law version of IRC section 1374.

The amount of the recognized built-in gain that passes through to the shareholders is reduced by the tax imposed on the built-in gain at the corporate level.

Double Deduction of Expenses

Examiners should analyze accounts to ensure that taxpayers are not deducting the same expenses more than once. Expenses may not be deducted twice by the same taxpayer, nor may the same expense be deducted on the books of numerous related entities of the taxpayer.

Earned Income Tax Credit

IRC section 32 provides for a refundable tax credit for low-income individuals who qualify.

The earned income tax credit for certain eligible taxpayers may require recomputation if earned income is adjusted.

Employment Tax

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 3320-102 (Rev. 10-96) TPDS 84238I. The training materials are also available on the IRS Home Page (<http://www.irs.ustreas.gov>).

The first step in any case involving worker classification is to consider section 530. Section 530 of the Revenue Act of 1978 was enacted by Congress to provide relief to certain taxpayers who had acted in good faith in classifying their workers from the potentially harsh retroactive tax liabilities resulting from IRS reclassification of independent contractors as employees. The statute is a relief provision and provides an alternative method by which to avoid employment tax liability where a taxpayer cannot establish his workers are or were independent contractors.

In order to qualify for section 530 relief, the business must meet consistency and reasonable basis tests. The consistency test requires that the business has filed all required Forms 1099 with respect to the worker for the period on a basis consistent with treatment of the worker as not being an employee (reporting consistency) and that the business has treated all workers in similar positions the same (substantive consistency).

Under the reasonable basis test, the business must have had some reasonable basis for not treating the worker as an employee. There are three “safe harbors” that form the basis for an objective reasonable basis standard under section 530. These safe harbors are: (1) judicial precedent, published rulings, technical advice to the taxpayer, or a letter ruling to the taxpayer; (2) a past favorable IRS audit on the same issue; and (3) long-standing, recognized practice of a significant segment of the industry in which the individual was engaged. A business that fails to meet any of these three safe havens may still be entitled to relief if it can demonstrate that it relied on some other reasonable basis for not treating a worker as an employee.

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 business’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). See *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, generally, the relationship of employer and employee exists when the person for whom the services are performed has the right to control and direct the individual who performs the services not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. The examiner will need to weigh 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.

Excise Tax

Taxpayers often use heavy motor vehicles to transport scrap metal. An annual highway use tax must be paid by the person in whose name the vehicle is, or is required to be, registered. The tax applies to vehicles over a specific gross vehicle weight rating. Publication 349, *Federal Highway Use Tax On Heavy Vehicles*, discusses the tax. An excise tax specialist can also be consulted if further guidance is needed in this area.

Inventory/IRC Section 263A

Inventories are required where the production, purchase, or sale of merchandise is an income producing factor. See IRC section 471; Treas. Reg. section 1.471-1. Many recipients of income from scrap metal sales are manufacturers that generate the scrap metal from their production processes. When examining the inventory of the manufacturer, analyze the costs to determine if the taxpayer has capitalized the proper amounts for direct and indirect costs. IRC section 263A establishes the uniform rules for cost capitalization. For instance, under Treas. Reg. 1.263A-1 (e)(3)(ii)(Q), scrap is considered an indirect cost of producing property. Manufacturers that produce scrap in the course of producing other property are required to capitalize the costs of the scrap metal to their produced property. On the other hand, scrap metal dealers are likely to have bidding, processing, pick-up, and other costs related to scrap metal that must be capitalized under section 263A to their scrap metal inventories.

Loans to Shareholders

Loans to shareholders should be analyzed to determine if the amount lent to the shareholder should be treated as a distribution to him or her. Some of the factors to be considered are as follows:

1. Closely held corporations--Loans with no expectation of repayment are more prevalent in closely held corporations, and loans of such corporations should be closely scrutinized.
2. Evidence of indebtedness--If there is no evidence of indebtedness or the terms of the note lack economic reality, there is a lesser chance that the loan will be accepted as a true loan. There is a greater chance it is a distribution to the shareholder.
3. Interest paid or accrued at the market rate--If interest is paid or accrued at a rate lower than the market rate, the loan is less likely to be treated as a true loan. If the interest rate is less than the market rate, the examiner should determine whether section 7872 has any bearing on the proper tax treatment of the loan.
4. Repayment schedule--If a repayment schedule does not exist or if the schedule is not adhered to, there is more evidence that the amount received by the shareholder should not be treated as a loan.
5. Dividend record of the corporation--This factor is considered along with the other factors mentioned here. Lack of dividend payments can demonstrate that the corporation is avoiding making distributions that will have a tax effect.

6. Collection efforts by the corporation--If collection efforts are not made when the loan is in default or if a demand loan has not been repaid within a reasonable period, the loan does not appear to be a true loan.
7. Ability to repay--If the financial position of the shareholder is such that it does not appear that the shareholder can afford to repay the loan, the amount may be properly treated as a dividend.
8. Treatment on books, tax returns, and financial statements of the corporation and shareholder--If the loans are not treated as loans on the documents stated above, there is less proof that the transactions were truly loans.
9. Authorized in minutes--True loans may be noted in the corporate minute books.

All these factors should be considered to determine if payments made to shareholders are loans or corporate distributions. Each case will depend upon the facts and circumstances that surround it.

Special Rules for Long-Term Contracts

Many sellers of scrap metal are manufacturers of property. These taxpayers may enter into long-term contracts.

IRC section 460 provides that income from long-term contracts shall be determined under the percentage of completion method. Pursuant to IRC section 460(f)(2), special rules apply for determining whether a manufacturing contract is a long-term contract.

Traffic Tickets and Fines

IRC section 162(f) provides that no deduction shall be allowed for any fine or similar penalty paid to a government for the violation of any law. Be aware that many states have laws that fine truckers for overweight violations. Scrap haulers may be subject to these nondeductible fines. See Treas. Reg. 1.162-21(c), Example (6).

Unreasonable Compensation

The issue of unreasonable compensation is frequently found in the compensation of employee-shareholders and relatives employed by closely held corporations. Shareholder-employees often attempt to disguise corporate distributions as salary so that the corporation may obtain a salary expense deduction that would not otherwise be allowable if the distribution were a dividend.

IRC section 162(a)(1) allows a deduction for a reasonable allowance for salaries or other compensation for personal services actually rendered. Reasonableness is determined by the facts and circumstances of each particular case. The following factors should be considered as general guidelines:

1. Nature and size of business--The likelihood that compensation will be unreasonable is much greater when it is calculated as a percentage of sales or earnings. Salary calculated on gross sales of the corporation rather than on sales made by the office or shareholder may indicate unreasonableness. Compensation based upon a percentage of sales or earnings must be reasonable in amount and based upon services actually performed.
2. Employee's qualifications--In determining the reasonableness of an employee's salary, the employee's background, experience, and accomplishments should be considered. Also, the duties and responsibilities of other officers and key personnel should be reviewed to determine if the duties overlap those of the employee whose compensation is under review for reasonableness.
3. Extent and scope of the employee's work--the amount of time that the employee devotes to the business is relevant. The shareholder's compensation should be compared with the effort of the shareholder.
4. Comparison of salaries with corporate income--The increase for salary may not be justified if the corporation's net income increases for reasons other than the employee's services, such as an increase due to changing market conditions.
5. Compensation paid by comparable business--Comparability studies for compensation may be researched in the following sources:
 - a. *Executive Compensation Series*, prepared by the Research Institute of America;
 - b. *Tax Management Report*, prepared by American Management Association; and
 - c. Research of Labor Statistics.
6. Compensation paid in prior and future years--Analysis of prior years' salaries must be made to provide evidence of the corporate intent to compensate for past services.
7. Fixed or contingent compensation--There must be a logical basis for computing the contingent element and the bonus, particularly in the absence of a long-standing plan.

8. Timing of compensation--Greater weight may be given to compensation determined early in the year versus compensation which is determined at year end.
9. Payment of dividends--The payment or nonpayment of dividends by a company should be considered. The omission of dividends may show that compensation is excessive. However, that alone would not support excessive compensation.
10. Compensation in proportion to stock ownership--When a corporation pays its officers in direct proportion to their stock ownership, there is evidence that the compensation is not for services actually rendered.
11. Prevailing economic conditions--Compensation tied to profits reflected by market conditions without a commensurate increase in the employee's duties, responsibilities, or value of services is unreasonable.

The factors stated above are based upon case law and research, and should be performed when an unreasonable compensation issue is considered. The determination of whether a shareholder-employee has received unreasonable compensation is based on all the facts and circumstances of each individual case.

This page intentionally left blank.

Chapter 4

Penalties

Penalties

While not all cases warrant the assertion of penalties, the penalties discussed below should be considered when applicable. As with any audit, penalties should be asserted only where the facts and circumstances of the individual case warrant their application. Refer also to the *Internal Revenue Manual* (IRM), that is, the *Penalty Handbook*, for more information. For additional information, contact your fraud coordinator regarding the applicability of the fraud penalties and refer to the Listing for Badges of Fraud contained in text 940 of IRM 4231.

Civil Penalties

Negligence

Consideration should be given to the assertion of the accuracy-related penalty if there is an underpayment of tax and the taxpayer has failed to maintain adequate business records. IRC section 6662 generally imposes a penalty on the portion of any underpayment due to negligence or disregard of the rules or regulations. The penalty is equal to 20 percent of the portion of the underpayment due to negligence or disregard of the rules or regulations. Negligence involves a lack of due care or failure to do what a reasonable and ordinarily 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.

Fraud

IRC section 6663 states in part that:

if any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud. If the Secretary establishes that any portion of an underpayment is attributable to fraud, the entire underpayment shall be treated as attributable to fraud, except with respect to any portion of the underpayment which the taxpayer establishes (by a preponderance of the evidence) is not attributable to fraud.

Failure to File Penalty

IRC section 6651(a)(1) provides for a penalty for failure to file tax returns. Unless the failure to file the return is due to reasonable cause and not due to willful neglect, 5 percent of the amount of

such tax is added to the amount required to be shown as tax on the return, if the failure is not for more than one month. If the failure is for more than 1 month, an additional 5 percent is added for each additional month or fraction thereof during which such failure continues, not to exceed 25 percent in the aggregate.

Fraudulent Failure to File Tax Return

IRC section 6651(f) provides for an increase in the delinquency penalty for fraudulent failure to file. The penalty is increased to 15 percent per month, to a maximum of 75 percent of the tax due. The burden is on the IRS to prove that the failure to file is fraudulent. You may consult the District Counsel for advice on legal or factual issues regarding this penalty.

Criminal Referrals

In the event that evidence of certain criminal activity is observed, it will be necessary to make a referral to the Criminal Investigation Division (CID), pursuant to IRM 4565.2. To assist in determining the types of activity that should be of concern, the following criminal provisions are described.

Fraud and False Statements

IRC section 7206(1) states that:

any person who . . . [w]illfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter . . . shall be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation), or imprisoned not more than three years, or both, together with costs of prosecution.

This sanction is a viable option when the Government is unable to establish an additional tax due.

IRC section 7206 states in part that:

any person who . . . [w]illfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document . . . shall be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution.

In addition, 18 USC section 371 conspiracy charges may be brought against parties engaged in schemes to underreport income derived from dealing in scrap metals. For example, where the parties to these schemes agree to provide false invoices or make checks out to fictitious payees, the parties may be considered to have entered into a conspiracy to evade tax or to generally defraud the United States.

Attempt to Evade or Defeat Tax

IRC section 7201 states that:

[a]ny person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.

Willful Failure to File Return, Supply Information, or Pay Tax

IRC section 7203 states in part that:

[a]ny person required under this title to pay any estimated tax or tax, or required by this title or by regulations made under authority thereof to make a return, keep any records, or supply any information, who willfully fails to pay such estimated tax or tax, make such return, keep such records, or supply such information, at the time or times required by law or regulations, shall, in addition to other penalties provided by law, be guilty of a misdemeanor and, upon conviction thereof, shall be fined not more than \$25,000 (\$100,000 in the case of a corporation), or imprisoned not more than one year, or both, together with the costs of prosecution. . . .

Fraudulent Returns, Statements, or Other Documents

IRC section 7207 states that:

[a]ny person who willfully delivers or discloses to the Secretary any list, return, account, statement, or other document, known by him to be fraudulent or to be false as to any material matter, shall be fined not more than \$10,000 (\$50,000 in the case of a corporation), or imprisoned not more than 1 year, or both. . . .

Failure to File Form 8300

IRC section 6050I(a) requires that any person is engaged in a trade or business, and who, in the course of such trade or business, receives more than \$10,000 in cash in either one transaction or two or more related transactions, file a return with respect to such transactions with the Secretary. Cash is defined to include not only U.S. and foreign coin and currency, but also

cashier's checks, bank drafts, traveler's checks, and money orders having a face amount of not more than \$10,000 if received in a designated reporting transaction or in any transaction in which the recipient knows that such instrument is being used in an attempt to avoid the reporting of the transactions under section 6050I. The return is made on Form 8300, *Report of Cash Payments Received in a Trade or Business*, and must be filed by the 15th day after receipt of the reportable amount (Treas. Reg. section 1.6050I-1(e)). In general, IRC section 6721(a) imposes a penalty for failing to file a Form 8300 in a timely fashion or provide the correct information of \$50 per return, not to exceed \$250,000 for all such failures in a calendar year. There is no requirement to file the Form 8300 if cash is received in a transaction reported under Title 31 by a financial institution or in a transaction occurring outside the United States. The penalty may be reduced or waived if the failure is corrected or if it is due to reasonable cause. See IRC sections 6721(b) & (c) and 6724 and the regulations thereunder. If the failure is due to intentional disregard, the penalty amount is increased to the greater of \$25,000 per failure or the amount of cash received in the transaction, up to \$100,000 per transaction (IRC section 6721(e)(2)(c)). This applies to intentional failures relating to cash received after November 5, 1990. For cash received prior to that date, the penalty for failure due to intentional disregard is the greater of \$100 or 10 percent of the aggregate amount required to be reported. The \$250,000 limitation on penalties per calendar year does not apply to intentional failures, and intentional failures are not counted in computing the \$250,000 limitation. See IRC section 6721(e)(3).

IRC section 6050I-1(e) requires that every person required to file a Form 8300 shall also furnish to each person whose name is set forth in the Form 8300 a statement showing the filer's name and address and the aggregate amount of cash set forth in the Form 8300. The statement must be provided on or before January 15 of the year following the calendar year for which the Form 8300 is required to be filed. Under IRC section 6722(a), the penalty amount for failing to provide the statement required under section 6050I(e) is \$50 for each failure, not to exceed \$100,000 in the aggregate per calendar year. When such failure is due to intentional disregard, the penalty is increased to the greater of \$100 or 10 percent of the amount required to be reported correctly per failure without limitation. Penalties for the intentional disregard are not taken into account in computing the \$100,000 limitation. See IRC section 6722(c). Penalties may be waived if the failures are due to reasonable cause. See IRC section 6724 and the regulations thereunder.

In addition to the civil penalties, any person intentionally violating IRC section 6050I may be subject to criminal sanctions. These criminal sanctions include IRC section 7203, Failure to File; IRC section 7206(1), Subscribing to a False Document; and IRC section 7206(2), Aiding and Assisting in the Preparation of a False Form 8300. Under IRC section 6050I(f)(2), the same civil and criminal sanctions that apply to the filer may also apply to a payor or other person who causes a failure or structures or assists in structuring a transaction to avoid the cash reporting requirements.

Chapter 5

Compliance Strategies

Coordination with Other Functions

To utilize the expertise of IRS personnel there should be coordination with the following areas:

1. National Office;
2. Region;
3. Examination Divisions (Computer Audit, Engineering, International);
4. Collection Division;
5. Appeals Division;
6. District Counsel; and
7. Other districts.

Involvement by personnel from many functions of the IRS can help ensure that cases will be handled uniformly. It can also foster discussion on the most appropriate way to handle noncompliant areas.

International

The examiner should be aware of possible international aspects that may be present during the examination of a scrap dealer. If the scrap seller is a resident alien or the sale is effectively connected with a trade or business in the United States, income from the sale is taxable in the United States on a net basis at the same graduated tax rates that apply to U.S. citizens. If the scrap seller is not a resident alien, or the sale is not effectively connected with a trade or business in the United States, then generally, the sale is taxable in the United States only if the income is U.S. source income. See IRC section 865(e)(2). If this is the case, the examiner should consider the use of a spontaneous exchange of information.

A spontaneous exchange of information is where certain information that may have tax implications in a country that has a tax treaty with the United States is provided to that country's taxing authority. Check the IRM for additional information. For example, a scrap dealer located in Michigan made many purchases from Canadian citizens who had brought their scrap into the United States. No information returns were filed by the U.S. taxpayer. As a result, an exchange of information detailing the Canadian sellers and the sales amounts was then forwarded to Canada. The Canadian tax authorities could then verify that the Canadian citizens were properly reporting these sales on their Canadian tax returns.

Another consideration in the international area pertains to the transportation of scrap between countries. When scrap is transported across countries' borders, various forms are required to be

filed with the two countries' customs departments. Presently, there are no restrictions or duties payable on shipments between the United States and Canada. For information on other countries, U.S. Customs should be contacted. If needed, certain information can be obtained from U.S. Customs in regards to cross-border shipments.

Computer Audit Specialist

A computer audit specialist (CAS) can provide assistance in developing a database that will record information on sellers of scrap metal. The CAS can also provide expertise in sorting and stratifying the data included in the database. If a taxpayer has a database already prepared, the CAS can be helpful in manipulating the fields so that the fields will correspond to the fields on the agent's database. This will enable the agent to include the taxpayer's information in the agent's database. If the taxpayer provides the agent with a flat file, the CAS can manipulate the data into a useful form to incorporate into the agent's database.

Engineering

Engineers can provide assistance in determining the type and amount of scrap metal that can result from certain business operations. They are also helpful in performing inventory valuations.

Collection

Involving the taxpayer in the collection process before the assessment is made can be very helpful in settling cases. Revenue agents should secure installment agreements if the tax liability, penalties, and interest are less than \$10,000. Some taxpayers are very apprehensive about recontacting the IRS to set up an installment agreement after the audit has been completed. If the tax liability, penalties, and interest are greater than \$10,000, a revenue officer can become involved with the case before the case is closed. Often the taxpayer will be more responsive to setting up an installment agreement at this time. Revenue officers can explain the payment arrangements to the taxpayer during the closing conference with the taxpayer. The revenue agent should secure the following information before contacting the revenue officer: copy of the last tax return filed by the taxpayer, information regarding the taxpayer's most recent sources of income, and any information regarding any bank or stock accounts that the taxpayer has.

Appeals

For appeals purposes, the revenue agent's report must be complete. The report should include everything that the agent wants Appeals to consider. Appeals will normally consider only the issues as stated in the report. Generally, if an issue is not in the report, it will not be considered. That is, if an issue revolves around the taxpayer meeting the requirements of the law and substantiation, state the issue as such. If the issue only mentions meeting the requirements of the law, Appeals will not look at the question of substantiation.

The report should provide all the facts of the case. A revenue agent may also provide opinions about the case which should be stated in the report. However, do not provide those opinions as part of the facts.

Be complete and give Appeals everything that is important to the issue.

District Counsel

In conducting an examination of a taxpayer engaged in the scrap metal business, revenue agents may contact their local District Counsel office for advice concerning legal or factual issues. This ensures cases are handled uniformly, thus promoting consistency in results on an industry-wide basis. Since many of these cases will involve factual issues, District Counsel may be helpful in evaluating whether there is sufficient evidence to support an adjustment. This would allow the revenue agent to better develop the case by obtaining additional necessary information.

Coordination with Industry Groups

In addition to working internally with other functions, working with industry groups such as the Institute of Scrap Recycling Industries (ISRI) is helpful. Industry groups can provide IRS with insights into the workings of the industry, as well as their members' concerns and questions on tax administration and compliance. It also affords the IRS the opportunity to educate the industry about the Service's compliance and enforcement processes and address compliance issues prevalent within the industry. With the cooperation of the industry, the Service can develop compliance strategies that would address taxpayer concerns while carrying out the mission of promoting compliance.

Compliance Letter

A compliance letter may be used by a District Director as an outreach effort to educate taxpayers about record-keeping responsibilities. Treas. Reg. section 1.6001-1 requires that taxpayers keep such permanent books and records, including inventories, as sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by the taxpayer's income tax return or information return.

The compliance letter may be used to heighten taxpayers' awareness of their record-keeping responsibilities. The compliance letter reminds the recipient that adequate books and records must be maintained; otherwise, their deductions may be subject to disallowance. The compliance letter does not place additional burden on taxpayers because adequate record-keeping is required by law for all taxpayers, regardless of whether a compliance letter is issued. Rather, the letter clarifies their responsibilities by citing specific examples of essential records that would generally be acceptable to verify their tax deductions.

A proforma compliance letter for scrap dealers can be found in Exhibit F. While the compliance letter does not place additional burden on the taxpayers receiving the letter, the industry has expressed some concerns about it. They are concerned that not all members of the industry are issued the letter, and also, the compliance letters that have been issued have differed from district to district as to the records to keep to substantiate purchases. Moreover, they have asked IRS to apply its resources so that all industry members, regardless of size or location, will be treated as fairly as possible.

In order to promote consistency and fairness to taxpayers, the National Office is recommending that districts planning to issue a compliance letter use the proforma letter in Exhibit F. Furthermore, it is recommended that the districts work with national associations that represent the industry, such as ISRI, and local recycling associations in their area to identify members of the industry within the district's jurisdiction. Letters should be sent to all industry members identified.

Note: The compliance letter is advisory in nature and is not to be treated as an inadequate records notice. Penalties should not be asserted for failure to follow the recommendations of the compliance letter. However, if a taxpayer has been issued a compliance letter and continues to maintain inadequate records, the examiner should consider disallowing the deductions and issuing an inadequate records notice. If the taxpayer has been issued an inadequate records notice and continues to not maintain the required records, then the assertion of penalties should be considered.

Appendix

Exhibit	Subject	Page Number
A.	Raw Materials of Metallic Scrap	A-3
B.	Cash Slip/Weight Ticket	A-7
C	Shipper	A-9
D.	Metal Settlement Report (1 of 2)	A-11
E.	Metal Settlement Report (2 of 2)	A-13
F.	Compliance Letter	A-15

This page intentionally left blank.

Raw Materials of Metallic Scrap

- ALUMINUM:** Aluminum is a comparatively new metal that has been produced in commercial quantities for less than 100 years, but is second only to iron in world consumption. It weighs about one-third as much as steel or copper, and because of its high strength-to-weight ratio, aluminum is ideally suited to aircraft, missiles, automobiles and trucks, and marine vessels. Primary sources of obsolete aluminum scrap are beverage cans, aircraft, automobiles, trucks, appliances, furniture, and electric utilities.
- CHROMIUM:** This metal is used to produce stainless, tool, and alloy steels and nonferrous alloys. Steel must contain at least 10 percent chromium to be considered stainless. The use of chromium enhances hardness and resistance to corrosion or oxidation.
- COBALT:** Cobalt is an essential element in many alloys and is vital in the aerospace and electrical product industries. Because of its heat resistance, high strength, wear resistance, and superior magnetic properties, it is used for cutting tools, jet engine parts, electrical devices, permanent magnets, and catalysts.
- COLUMBIUM:** Columbium is used as an alloy in high-strength, low-alloy steels, and superalloys. It is used in pipeline and tubular steels, in titanium base alloys for deep sea submersibles, in various superconductor materials, and in aircraft fasteners.
- COPPER:** This red metal is widely used for its electrical and thermal conductivity, its chemical stability, and its workability. Brasses are copper alloys containing zinc as the principal alloying element. Bronzes are copper alloys in which the principal alloying elements are tin and zinc. Other classes are copper nickels, copper-nickel-zinc alloys, and leaded coppers. Automobile radiators, telephone and utility wire and cable, tubing, electrical motors, generators, ammunition shell cases, plumbing fixtures, and railroad equipment are major sources of obsolete red metals.

Exhibit A (2 of 4)

- GOLD:** In addition to its importance as a monetary base and in jewelry, gold is critical to industry. Complex electronic circuitry, including that used in computers, requires gold.
- Gold, as well as gold-brazing alloys, is used to bond turbine blades in jet aircraft engines to their rotors.
- IRON:** When carbon is added to iron, steel is formed. Through the centuries, other elements have been added to the iron and carbon mixture to produce a multitude of steel grades. Steel is the most widely used metal alloy in the world. It is present in transportation and construction products, all kinds of industrial equipment and machinery, and in appliances.
- LEAD:** The major use is for batteries for energy storage. It is also used in ammunition and electrical cable sheathing. Scrapped batteries account for the majority of recovered lead. As a percent of output, lead is the most recycled metal.
- MANGANESE:** Manganese is essential to produce steel and to control oxygen and sulfur that make steel workable. It also improves strength, toughness, and hardenability. It is a common constituent in a number of other metals. It is present in all cast iron as well as steel, and in many varieties of brass, aluminum bronze, and in aluminum- and nickel-base alloys.
- MAGNESIUM:** Magnesium is used as an alloy with other metals such as aluminum, and as a reducing agent for metals such as titanium, zirconium, and uranium. It is used in aircraft, automotive, and other types of transportation and material-handling equipment.
- MOLYBDENUM:** This is used in stainless and alloy steels, in high-strength, low-alloy steels, and in tool and high-speed steels. “Moly,” as it is called in the trade, improves hardenability and toughness, resists abrasion and corrosion, and enhances strength, particularly at high temperatures.
- NICKEL:** Nickel is vital to the steel industry for use in alloys with other elements to add strength and corrosion resistance over a wide

range of temperatures. The most common form of stainless steel contains 18 percent chromium and 8 percent nickel. Superalloys, which are usually nickel-based, contain more than 50 percent nickel and are used in such products as aircraft turbines that require high temperature strength.

PLATINUM:

Platinum is one of six closely related metals referred to as the platinum group. They are platinum, palladium, rhodium, iridium, ruthenium, and osmium. Scarce and expensive, they were used primarily for jewelry until the last three or four decades. Usually they perform one of two functions serving as catalysts in the chemical, petroleum, refining, and automotive industries (catalytic converter), or serving as corrosion-resistant materials in the chemical, electrical, glass, and dental-medical industries.

SILVER:

The largest domestic use of silver is in the production of photographic materials. It provides high electrical conductivity (higher than copper), resistance to oxidation, and strength at a wide range of temperatures. As a result, it is often used as a contact metal in switches.

TANTALUM:

Capacitors for computers and automotive and military applications are made with tantalum.

TIN:

One of the earliest known metals to man, tin was used in bronze as early as 3500 B.C. Today, most tin is used as a protective coating (tin plate) for steel containers, in solders, and in other alloys - including chemicals, for widely diversified applications. The U.S. either imports or reclaims virtually 100 percent of its annual tin requirements. Tin is being recycled from tin plate and used container scrap, as well as from solder drosses.

TITANIUM:

The space industry consumes the majority of titanium. It is also used for pipe and tubing for surface condensers in power plants, for heat exchangers in the chemical industry, for water desalination evaporators, and as plate, pipe, and tubing for chemical process equipment.

TUNGSTEN: Tungsten maintains its hardness even at extremely high temperatures. It is used in high-speed tools, die steels, superalloys, and nonferrous alloys. The chief nonindustrial use of tungsten is in armor piercing ordnance. Alloyed with copper and silver, it is used for electrical contacts providing wear resistance with adequate electrical conductivity.

ZINC: One of its most important uses is as a protective coating (galvanizing) on steel. It is also widely used to make die castings for automobile and construction applications, as an alloying element with copper to make brass, and as a chemical compound in rubber and paints. Although the tonnage of zinc die casting used by the automotive industry has been steadily declining, the percentage of zinc die cast scrap recovered from shredded automobiles has increased virtually 100 percent.

ZIRCONIUM: A primary application is its use in commercial water-cooled reactors for fuel cladding and pressure tubes. It is also used in corrosion-resistant applications in the chemical industry.

Reprinted from *Recycling Nonferrous Scrap Metals* (copyright 1990, 1993), by permission of the publisher, Institute of Scrap Recycling Industries, Inc.)

Cash Slips/Weight Tickets

<p>Smith Iron & Metal Co. 12345 Shelby Detroit, Michigan 48179 (313) 555-5555</p>	
BOUGHT FROM	_____ 19 _____
<p>_____ Tipton Stamping Company _____ _____</p>	
MATERIAL:	<p>3003 Aluminum</p>
GROSS	_____ 14950# _____
TARE	_____ 2000# _____
NET	_____ 12950# _____
	_____ .50# _____
PAID	
CASH _____	
CHECK	
NO. _____	

This document serves as a cash slip/weight ticket and is prepared by the processor after buying scrap. If the seller does not receive payment when the processor takes possession of the scrap, the individual cash slips/weight tickets will be summarized on the metal settlement report, which is shown on Exhibits D and E. The seller will then receive payment for a number of loads in one lump sum.

Gross =Weight of scrap, containers, trucks, trailers, etc.

Tare =Weight of containers, trucks, trailers, etc., without the scrap.

Net =Gross weight less the tare weight. This represents the weight of the scrap.

This page intentionally left blank.

Shipper

SHIPPER		NO. 05265
Tipton Stamping Company 67890 Yuma Detroit, Michigan 48111 Phone: (313)555-2020		
To	Smith Iron & Metal Co.	Date _____ Cust. Order No. _____ Job. No. _____
QUANTITY	DESCRIPTION	
1	LOAD OF STAINLESS STEEL	

When a scrap processor takes scrap metal from a seller's business location, a shipper is prepared by the seller to document the removal of the scrap. In most cases, a general description of the scrap metal is included on the shipper. The weight of the scrap usually is not recorded on the shipper because most sellers do not have a weight scale on the business premises.

This page intentionally left blank.

Metal Settlement Report (1 of 2)

Smith Iron & Metal Co. 12345 Shelby Detroit, Michigan 48179					
Tipton Stamping Company 67890 Yuma Detroit, Michigan 48111			Date: 10/10/94 Page: 1		
Ticket #	Date	Description	Net-Wgt	Price	Amount
37147	10/01/94	Aluminum - 3003	12950#	.50lb	\$6,475.00
37230	10/04/94	Stainless Steel	30100#	70.00GT	940.62
37350	10/08/94	Machine Castings	1000#	30.00GT	13.39
TOTAL:					===== \$7,429.01 =====

A scrap processor may receive scrap from a seller at various times before the seller is paid. When this occurs, the scrap processor may provide a statement that summarizes the various scrap sales. This detail is taken from the individual cash slips and weight tickets. See Exhibit B for a sample of a cash slip/weight ticket. Another example of a metal settlement report is presented in Exhibit E.

GT =Gross Ton (2,240 lbs.)

This page intentionally left blank.

Metal Settlement Report (2 of 2)

SMITH IRON & METAL CO. 12345 Shelby * Detroit, Michigan 48179 * Phone (313)555-5555 Date _____, 19____					
Purchased From:		Tipton Stamping Company 67890 Yuma Detroit, Michigan 48111			
	Grades and Weights				
DATE	3003 ALUMINUM	STAINLESS STEEL	MACHINE CASTINGS		
10/01/94	12950#				
10/04/94		30100#			
10/08/94			1000#		
TOTAL WEIGHT	12950#	30100#	1000#		
PRICE	\$.50/LB	70.00GT	30.00GT		
EXTENSION	\$ 6,475.00	942.62	13.39		\$ 7,431.01
ADJUSTMEN T					\$ -0-
ADJUSTMEN T					\$ -0-
TOTAL					\$ 7,431.01

This is an example of a metal settlement report prepared by the scrap processor. See Exhibit D for another example of a metal settlement report.

This page intentionally left blank.

Example of Compliance Letter

INTERNAL REVENUE SERVICE

DEPARTMENT OF THE TREASURY

District
Director

Person to Contact:

Telephone Number:

Refer Reply to:

Date:

Dear Recycler:

As part of our review of tax compliance in several industries, the Internal Revenue Service has determined records maintained by the recycling industry may be insufficient to verify the accuracy of purchases of recyclable materials. The concern affects the buyer, who takes a deduction for the purchase, as well as the seller, who may be required to report the sales proceeds.

It is the responsibility of taxpayers to maintain adequate records to substantiate items on their tax returns, including purchases of recyclable materials. Failure to maintain such records could result in the assessment of additional tax due to the disallowance of deductions. Accordingly, we suggest that you maintain for all purchases documentation that includes a description of the recyclable material purchased - type, weight (or other measure of goods purchased), total amount paid, and the date of the purchase. Additionally, for cash purchases, we suggest that you maintain the following documentation:

- (1) The seller's full name and/or the company they represent.
- (2) The seller's or company's complete address to include:

Number and street
Apt. or suite no.
City or town, state, and zip code

(If a seller's address is outside of the United States then include Number and street, City, province or state, postal code, and the name of the country.)

- (3) Signature of the person who receives payment for the sale of recyclable materials,

- (4) The seller's driver's license number, or other identifying information such as a Department of Public Safety Identification Card, a military identification card, a passport, a United States Immigration and Naturalization Service work authorization ("Green Card"), or the license tag number of the vehicle used by the seller.

We appreciate your cooperation and willingness to work with us on this matter. By studying the reasons for non-compliance, we are able to increase and maintain voluntary compliance. In meeting the Service's goals for effective tax administration, we will strive to apply resources to compliance visits across all levels of the recycling industry, regardless of size or location. If you have any questions, please contact the examiner named at the heading of this letter.

Sincerely,

Chief, Examination Division

Bibliography

Doyle, Lawrence. *Manufacturing Processes and Materials for Engineers*. Englewood Cliffs, NJ: Prentice-Hall, Inc., 1961, 1969.

Office of Management and Budget. *Standard Industrial Classification Manual*, 1987.

Recycling Scrap Iron and Steel. Institute of Scrap Recycling Industries, Inc., 1990, 1993.

Recycling Nonferrous Scrap Metals. Institute of Scrap Recycling Industries, Inc., 1990, 1993.

Scrap: America's Ready Resource, Institute of Scrap Recycling Industries, Inc.

The Scrap Map: An Environment Publication for Grades K-6. Institute of Scrap Recycling Industries, Inc., 1990.

Scrap Recycling: Where Tomorrow Begins. Institute of Scrap Recycling Industries, Inc., 1996.

This page intentionally left blank.

Glossary

- Alloys:** A mixture of two or more metals.
- Baler:** A machine used to compress scrap metals and bundle them into different size parcels.
- Broker:** A person who acts as an intermediary or third party between the buyer and seller of scrap metal.
- Cash Slip:** A document that records the type and weight of the scrap being purchased and shows the amount that was paid for the scrap. Refer to Exhibit B.
- Casting:** A process by which molten metal is poured into a mold and allowed to solidify.
- Containers:** Receptacles used to accumulate scrap metal by the person who generates the scrap. Examples of the different types of containers are hoppers, roll-off containers, drums, luggers, and bins.
- Conveyor:** A device with a continuous moving belt that can move scrap from one place to another.

Currency and Banking Retrieval System:

A database in which various monetary transaction reports are compiled. Of particular interest are the following forms:

Form 4789, *Currency Transaction Report*, is filed by financial institutions for cash transactions over \$10,000. It identifies the individual making the transaction, the person or organization for whom the transaction was conducted, the institution reporting, and the amount of money involved.

Form 4790 details the international transportation of currency or monetary instruments. Persons transporting either of these must declare themselves to Customs when leaving the United States or when entering with funds to be declared from ex-U.S. sources. Persons who mail or ship funds must also complete Form 4790.

Form 8300 is a report of cash payment over \$10,000 either in U.S. dollars or the foreign currency equivalent received in a trade or business. It is to be filed by businesses receiving more than \$10,000 in cash. The information required to be reported includes the name and taxpayer identification number of the payor and the date and nature of the transaction.

Form TDF 90-22.1 is required to be filed by entities having a financial interest in or signature authority over foreign bank and financial accounts with an aggregate value of more than \$10,000.

Revenue agents can obtain printouts of any transactions reported from the CBRS in the Detroit Data Center.

Ferrous

Scrap: Scrap iron and steel.

Forging: The process of working metal parts into a shape by means of hammering or pressing the material after it has been rendered pliable by heating it to a high temperature.

Foundries: An establishment in which metal is cast.

Grapple: A device with claws at one end for grasping and holding.

Home

Scrap: Scrap that is generated as steel mills and foundries form new products. The scrap generated is usually remelted and used again at the same plant.

Industrial

Scrap: Scrap that is generated through a manufacturing process, such as stamping, drilling, or shearing. Industrial scrap is often referred to as new or prompt scrap.

Loader: A vehicle that moves scrap.

Magnet: A device attached to a crane and is used to pick up and move scrap metals.

Metal Settlement

Report: A statement that summarizes various scrap purchases. The detail on the statement is taken from the individual cash slips/weight tickets that are generated for each pick-up. Refer to Exhibits D and E.

Mills: A factory where metals are worked into standard shapes suitable for fabrication into commercial products.

Mini-Mills: A factory similar to a mill that uses a substantial amount of scrap metal to make steel.

Nonferrous

Metals: Metals that contain little or no iron. They include aluminum, copper, lead, tin, zinc, and precious metals such as gold, silver, platinum, magnesium. Nonferrous metals also include specialty metals such as titanium, cobalt, chromium, and tungsten and metal alloys made of a combination of two or three metals, such as brass-made of copper and zinc, bronze-a blend of copper, and tin and zinc.

Obsolete

Scrap: Scrap generated from items that have outlived their usefulness, such as metal from buildings, homes, industrial equipment, and autos.

Ordinance: Military weapons, ammunition, and equipment used to maintain the weapons and the ammunition.

Peddler: A person who purchases scrap metal and resells it to a scrap processor.

Scrap Processors

(Scrap Dealers, Scrap

Recyclers): Businesses that buy scrap metal and eventually sell it to mills and foundries for remelting.

Shears: Equipment used to cut scrap metal.

Shipper: This statement is generated by a seller of scrap metal when the scrap is removed from the seller's location. In most cases, a

general description of the scrap metal is recorded on the shipper. Refer to Exhibit C.

Shredder: A machine that hammers scrap metal into small pieces. The pieces are then separated into ferrous metal; nonferrous metals; and nonmetallics, generally not further separated at this time, including debris.

Weight Ticket: This statement records the type and weight of the metals purchased by the processor and the price paid for the metal. Refer to Exhibit B. There are instances where a weight ticket may only include the weight of the scrap metal. This information is then transferred to a cash slip/weight ticket.