



## Market Segment Specialization Program



# Reforestation 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.



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# Reforestation Industry

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## INTRODUCTION

This report is a culmination of the results of the work performed by a team of individuals from Examination, Collection, and the State of Oregon Revenue Department. The primary objective of this group was to evaluate compliance within a specific group of taxpayers and to develop an industry/project report to be used as a reference tool by State and Federal examiners. A team audit approach was used to maximize audit resources and develop communication lines between the State of Oregon Revenue Department, the Examination Division, and the Collection Division of the Internal Revenue Service.

The team consisted of four revenue agents from Examination, one revenue officer examiner from Collection, one tax auditor from Examination, one revenue agent from the State of Oregon, and an audit accounting aide from Examination. The audit techniques presented in this report were used by the examiners and have been found to be useful within this industry.

The basic goals of the members of this team are outlined below:

1. To determine if compliance was a problem in this industry.
2. To determine if the contractors were filing all required Federal and State returns: Income tax, employment tax, and information returns.
3. To determine if the Federal and State returns filed by the contractors were substantially correct.
4. To make the appropriate recommendations to the proper State and Federal agencies, in order to strengthen voluntary compliance within this industry.

This report is based upon information gathered from a limited number of examinations. It is, therefore, not to be considered all inclusive or absolute as to its contents. The primary purpose of the report is to provide some general and technical information which should be useful to an examiner in the classification, pre-planning, and examination of returns selected in the reforestation industry.

The audit areas identified and discussed in this report were considered to be significant or unusual enough to warrant comment. The mere fact that an item is addressed in this report does not imply, in any manner, that it must or should be examined in every case. To the contrary, it is intended that the discussion for any one audit area will assist the examiner in deciding whether the item would warrant examination on a case by case basis. This handbook was developed as a reference tool and should be used as a supplement to the manual.

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## Chapter 1

### RETURN SELECTION PROCESS

#### RETURNS SELECTED FOR THIS PROJECT

Contractors were selected from the list of licensed Farm/Labor Contractor's, provided by the Bureau of Labor & Industry, Wage and Hour Division. A data base of the licensed contractors owning businesses in Salem, Woodburn, Mt. Angel, and the surrounding area was developed. AIMS was researched to locate social security numbers and addresses of the licensed contractors. Once a social security number was obtained, a transcript was ordered to determine if the contractors were filing Federal tax returns. Copies of selected contractors' returns filed with the State of Oregon were secured from the Department of Revenue under our information exchange agreement. The returns examined were selected based on prior knowledge of the types of expenses common to the reforestation industry and whether or not the items reported on the return appeared either large or unusual. The returns selected for examination were either individual Forms 1040, Subchapter S-Corporations, or C-Corporations. The group examined 9 prime contractors, 3 second-tier subcontractors, and 20 individuals who filed Federal returns Form 1040. The State of Oregon revenue agent examined the Corporate Income Tax Returns for three S-Corporations and one C-Corporation. The second-tier contractors were selected by expanding the "package audit" during the examination of the prime contractor. In other words, when a prime contractor was audited, the examiners reviewed certain documents (such as canceled checks, invoices, and Forms 1099) pertaining to subcontractor payments. The subcontractors who received large payments were identified and again transcripts were requested to determine if they filed Federal and State tax returns. We selected subcontractors that were filing employment tax returns and also subcontractors that were not filing either income tax returns or employment tax returns. During the classification process and the examination process, the group identified audit issues which appeared to be common within this industry. The following is a list of the audit areas that were identified:

1. There were large numbers of nonfilers.
2. Circumvention of employment tax liabilities and worker's compensation premiums by failing to file employment tax returns, paying wages in cash, and classifying all payments to workers as subcontractor payments.
3. Employees in this industry are issued Forms 1099 for the above reasons. These individuals offset their Form 1099 income with expenses -- either paid by them or

their employer, and subsequently qualify for a earned income credit.

4. Sums of large amounts of income. Internal control is usually poor and leads to underreporting of income earned from Federal and State agencies, from other contractors, private companies, or other unrelated business activities.
5. Poor accounting records lead to unsubstantiated expenses. Reforestation contractors contend that they do not have the expertise to maintain quality books and records.
6. Returns are being prepared by unlicensed preparers. A preparer reported that he was being paid for bookkeeping services, not for preparing tax returns, and, therefore, was not required to sign the returns.

## **SUGGESTED SEQUENCE OF SELECTING CONTRACTORS FOR EXAMINATION**

### **Step 1: Identifying the Prime Contractor**

Reforestation contractors working in Oregon are required to obtain a Farm/Labor Contractor's License. To secure a listing of licensed Oregon contractors you need to contact the State of Oregon, Bureau of Labor and Industries, Wage and Hour Division. Oregon is the only known state that requires the contractors to have a license; however, the Bureau of Labor and Industries in your state will be able to give you more information on their policies.

Another possible resource for locating reforestation contractors is PSPB or the Department of Revenue in your state. PSPB and the Department of Revenue have the capability of running a listing of returns with specific Principle Industry Activity Codes, (PIA Codes). This may be something that your Disclosure Officer can secure for your area. Finally, you may be able to request a list of contractors from the Forest Service or the Bureau of Land Management. These agencies are required to maintain a current mailing list of contractors who wish to receive the current announcements of solicitations. Chapter 2 of this handbook, lists addresses, and telephone numbers of Oregon and Washington regulatory and licensing offices where you can secure information about reforestation contractors.

### **Step 2: Selecting Second-tier Contractors for Examination**

While completing the expanded "package audit" the examiner should concentrate on those subcontractors with the highest dollar volume. A good starting point is to review the Forms 1099. In addition, the disbursements journal should be reviewed for other large volume contractors who were not issued a Form 1099, since, 1) the prime contractor may not be issuing a Form 1099 to all subcontractors, and 2) Forms 1099

are not required to be issued to corporations, and contractors are sometimes organized as corporations to circumvent the Form 1099 filing requirements.

### **Step 3: Identifying Disbursements to the Selected Subcontractors**

In preparation for reviewing the key documents (canceled checks), disbursements made to the subcontractors selected in Step 2 must be identified by check number, date, and amount. It has been our experience that the contractors do not maintain summaries of their cash disbursement journal so it will be helpful to create a data base of payments made to individuals and the checks issued to cash. This information will be invaluable for the following reasons:

1. The list will give you a starting point when analyzing a subcontractor's bank deposits since the contractor may be cashing payments received from the prime contractor at the prime contractor's bank.
2. Prime contractors may be issuing checks to cash and paying the subcontractors in cash.
3. The prime contractor may file a Form 1099, but exclude certain payments made to the subcontractor.

### **Step 4: Inspect Canceled Checks**

The next step is to pull the checks for each selected contractor and to review the endorsements. The examiner will be looking for checks that were cashed in unusual ways. For example, they may have been converted to cashier checks, cashed at the payor's bank, cashed at a check-cashing business, deposited to a bank account located in another city, or endorsed to another individual. Because contractors normally operate as closely held family businesses, with few accounting controls in place, failure to deposit normal business receipts is a good indication that the income is not being reported for tax purposes.

### **Step 5: Select Subcontractors for Audit**

After completion of Step 4, the examiner will have identified one or more contractors whose audits will spin-off. He or she would be well advised to request the payment detail for these contractors for the subsequent year as well. Requesting information in the early stages is advisable since it may become increasingly difficult to obtain documents as the audit progresses.

### **Step 6: Secure Documents for the Subcontractor File**

The information to be accumulated for each contractor that will be spun-off should include as much of the following as is available:

1. Forms 1099
2. Front and back of all checks issued to the subcontractor
3. Any identification information that the prime contractor may have on the subcontractor, such as past and current addresses, telephone numbers, business names, invoices, and social security numbers.

### **Step 7: Other Sources of Information for Locating Subcontractors**

If the address or social security number retained by the prime contractor does not help you in locating the subcontractor, you can call the Corporate Commissioner to obtain the address of the business and the names and addresses of the registrants. We have found that it is common for individuals to register an assumed business name with the Corporate Commissioner and give the name and address of several registrants. (For information on Oregon businesses you can call (503) 378-4166). The Department of Insurance and Finance can be a helpful source for locating subcontractors. This agency maintains a list of individuals and businesses who currently have worker's compensation coverage. If the subcontractor currently has coverage, you can obtain his or her home address. The Department of Insurance and Finance can also give you information about a business and tell you whether or not the business has registered for coverage as a partnership, corporation, or as a sole proprietor. (In Oregon you can call (503) 378-4954). As previously mentioned, the Bureau of Labor and Industries, Wage and Hour Division will have names and addresses of all licensed contractors. (In Oregon you may call (503) 378-3292).

## Chapter 2

### NATURE OF OPERATIONS

#### **OVERVIEW OF THE INDUSTRY**

This MSSP Guide is designed to assist examiners in completing examinations of reforestation contractors. A contractor working in the reforestation industry may secure service contracts, (pre-commercial thinning and tree planting contracts) from a Federal agency, a State agency, from private companies, or other contractors. Keep in mind that State and Federal agencies issue several types of service contracts; examples are fire fighting, cone collection, tree netting, tree shading, gopher baiting, etc. At this time it does not appear that the reforestation-station contractors bid for service contracts other than tree planting and tree thinning. However, no industry is stagnant and this may be something that contractors may expand into in the near future as they develop expertise in the reforestation industry. Since the most predominant type of service contract issued by the Federal and State agencies are pre-commercial thinning and tree planting contracts, the scope of this Guide has been limited to reforestation contracts only.

#### **FEDERAL AND STATE AGENCIES ISSUING REFORESTATION CONTRACTS**

The following Federal and State agencies have the authority to solicit individuals to do pre-commercial thinning and tree planting:

1. The Bureau of Land Management (BLM)
2. The U.S. Department of Agriculture Forest Service
3. The Small Business Administration Section 8A Program (the Small Business Administration under Federal Equal Opportunity regulations are set up to award, to qualified section 8A contractors, 10 percent of all Forest Service and BLM contracts. They do not monitor the contracts or make payments. The Forest Service or BLM continues to perform these services).
4. State agencies, such as The Oregon Department of Agriculture Forest Service and Oregon Department of General Services.

## **PRIVATE COMPANIES ISSUING REFORESTATION CONTRACTS**

There are many private companies involved in producing timber products who may issue tree planting or tree thinning contracts, (that is, lumber mills, sawmills, veneer plants, plywood plants, and in some instances logging companies). Private companies issue tree planting or thinning contracts to either replant or maintain their own timber lands or to comply with the terms of a Federal or State contract. Certain states have legal requirements requiring all forest lands be replanted; these laws may cover both public and private lands. Private companies who purchase timber stands from Federal and State agencies agree to replant the land after harvesting the timber. There is a pattern of these private contractors employing the reforestation contractors on a regular basis.

Copies of contracts issued by private companies were requested; a review of these private contracts did not reveal any significant differences from those issued by the Federal and State agencies. The contracts reviewed by the group were written agreements between the company and the contractor and specify that the reforestation contractors will follow the applicable State and Federal laws while they are engaged to plant trees or for tree thinning.

## **TYPES OF CONTRACTS**

This report concentrates on the requirements of securing contracts from the Federal and State agencies for two reasons: First, there are more contracts issued by the State and Federal agencies than by private companies. And secondly, it is more difficult to obtain information from private companies since this information is not public record as is the case with the Federal and State agencies.

Federal procurement regulations allow Federal agencies to solicit bids from prospective contractors for three major types of contracts: Service, supply, and construction. As previously mentioned, only service contracts are discussed since pre-commercial thinning contracts and tree planting contracts fall in this area.

Services are considered to be work that requires the direct engagement of the contractor's labor with the goal of performing an identifiable task rather than to furnish an end item of supply. This would include tree planting, tree thinning, cone collection, brush piling, etc. However, the term "service" excludes work done by the construction trades. (The group members have not researched either construction or supply contracts).

The State and Federal agencies have further divided thinning contracts into: 1) pre-commercial thinning contracts and 2) commercial thinning contracts. It becomes important to understand the difference between the two types of thinning contracts

since it will enable you to be more successful in obtaining third party information. Probably the most important thing to remember is that these contracts do not fall under the same Federal Regulations nor will one contractor be qualified to work both types of contracts.

Pre-commercial thinning contracts are issued by the Forest Service to thin young forests (10 to 20 years of age). The young forests are thinned to cull undesirable trees, (such as oak, pine, and damaged firs) to give the remaining trees more room to grow.

Commercial thinning contracts, on the other hand, are issued by the Forest Service to selectively harvest mature trees. The Forest Service negotiates commercial contracts have certain lands selectively harvested versus clear cut, as in the case of standing timber sales. Commercial thinning contracts are not considered to be reforestation contracts.

### **GENERAL REQUIREMENTS FOR STATE AND FEDERAL AGENCIES**

Pre-commercial thinning contracts or tree planting contracts fall under State and Federal regulations. To illustrate, in the State of Oregon, to become a prime contractor the individual must provide the following:

1. A valid Farm/Labor Contractor's License (applies in Oregon; check to see if there are similar requirements in your state).
2. Verification of Worker's Compensation coverage.
3. A Bid Bond or Performance Bond.
4. Agreement, under penalties of perjury, to follow all State and Federal labor laws.

Federal and State contracts are guided by a series of laws and are enforced by several agencies. The Bureau of Land Management, the U.S. Department of Agriculture Forest Service, the Small Business Administration Section 8A Program, and the Oregon Department of Agriculture Forest Service enforce the operational aspects of the contracts guided by various Federal procurement regulations. Other Federal agencies, such as the Department of Labor and the Immigration & Naturalization Service, enforce regulations in relation to wages and the legal status of workers. State agencies are also involved. The state of Oregon's Bureau of Labor & Industry and the Department of Insurance and Finance enforce or monitor regulations governing licensing and Worker's Compensation coverage.

**State of Oregon - Bureau of Labor and Industries - Wage and Hour Division - Oregon Farm/Labor Contractor's License**

All solicitations for reforestation contracts (including, but not limited to, tree planting, brush clearing, and pre-commercial tree thinning, prescribed burn services, or contracts for cultivation of a crop) will contain the requirement for the Farm/Labor Contractor's Certification of Registration. A Notice to Proceed will not be issued without positive proof of the certification. Application for registration numbers would be made to the Department of Labor office.

The contractors are required to provide a bond before a Farm/Labor Contractor's License will be issued and provide a certificate of worker's compensation coverage. The cost of the license is \$100.

Beginning July 1989, Wage and Hour Division is requiring a \$10,000 bond, up from \$5,000, and the contractors must take an examination before their license will be renewed. The examination pertains to the laws in various areas, (such as Worker's Compensation, Occupational Safety and Health Administration, Wage & Hour, and Forestry).

Once the contractor has received a license and begins working reforestation contracts, he or she must file a certified payroll every 35 days with the Bureau of Labor and Industries, Wage and Hour Division (BOLI). The certified payrolls will list employee names, their gross wages, and the amount withheld for taxes. BOLI uses the certified payrolls as a measurement device to determine whether or not contractors are complying with State wage and hour laws.

BOLI is looking for contractors who do not pay wages, since the failure to pay wages is grounds for withdrawing the Farm/Labor Contractor's License. All records maintained by BOLI are public. BOLI has changed the expiration date of the Farm/Labor Contractor's License to spread their workload. In prior years all licenses expired on January 31. Currently, the expiration date is determined as follows:

1. The date of incorporation is the renewal date for all corporations.
2. The date of birth of the oldest partner will be the renewal date of the partnership.

All partners in a partnership must now have a \$10,000 bond. A lesser aggregate bond can be negotiated if the contractor has a clean record. The contractors are allowed a 25-percent reduction in the aggregate amount due each year their record stays clean. The minimum bond they would be required to provide would be \$10,000 or 25 percent of the total aggregate, whichever is larger.



### **Example 1**

The partnership has five partners. The total bonding due would be: 5 x \$10,000 or \$50,000. With a clean record it would be reduced to: \$50,000 x 75 percent or \$37,500. The next year with a clean record it would be reduced to: \$50,000 x 50 percent or \$25,000. The next year with a clean record it would be reduced to: \$50,000 x 25 percent or \$12,500. This would be the lowest amount the partnership would be allowed to pay. If 25 percent of the aggregate had equaled less than \$10,000 then the partnership would be required to pay \$10,000.

A corporation will have to provide a bond for the majority shareholder and any other active stockholder in the corporation. The same rules apply to the aggregation and reduction as with partnerships.

The prime contractors and all first-tier subcontractors shall be required to obtain and maintain a Farm/Labor Contractor's License. Contractors not having a current license will be required to furnish evidence of having obtained such license within 10 days after receipt of written notification of the contract award. Failure to obtain, keep, or maintain a current license during the term of this contract or the extension thereof shall be basis for termination or default.

Contractors living in Oregon may bid and receive contracts in other states, (that is, Northern California, Washington, Idaho, etc.). Oregon contractors are not required to have or maintain an Oregon Farm/Labor Contractor's License to work contracts outside of Oregon. However, Oregon contractors who have lost their license normally will continue working in the industry although they now are required to work outside of Oregon.

The Forest Service, the Small Business Administration, and the Bureau of Land Management do not have the authority to ensure that the first-tier subcontractors have a valid license. This causes concern because it allows the prime contractors to use unlicensed subcontractors. The system is not fail proof and Oregon contractors can find ways of hiring unlicensed contractors within the law. You could find an Oregon contractor paying subcontractor payments to a first-tier subcontractor who lives in Oregon but does not have a license. For example, a first-tier sub-contractor, whose tax home is in Oregon, works for an Oregon contractor in California. Whether or not the Federal agencies are able to enforce the licensing requirement at the first-tier subcontractor level depends on their working relationship with the prime contractor.

Another important point to remember is that the State of Oregon, Bureau of Labor & Industries, Wage and Hour Division has no authority to enforce the hourly wage rates set by the U.S. Department of Labor. The State of Oregon has no set amount that

must be paid to reforestation workers, with the exception of the minimum hourly wage rate. According to BOLI, they have tried to set a standard of \$6 to \$7 per hour for employees in this industry.

### **Workers' Compensation Carrier - SAIF Corporation**

According to the terms of the Federal and State pre-commercial thinning contracts and the tree planting contracts, all prime contractors must carry worker's compensation on their employees. SAIF requires that the prime contractor carry worker's compensation coverage regardless of whether or not their subcontractors are covered.

SAIF is only one of the companies providing worker's compensation in the State of Oregon. There are approximately 250 worker's compensation insurance companies covering the state. There are six large companies. The three main ones which would probably cover contractors in the reforestation industry are: SAIF, Liberty Northwest, and Employers of Wausau. The Oregon Worker's Compensation rates range from \$51 to \$34 per every \$100 of payroll. This amount varies by year and will go up or down depending on the contractor's work record. According to SAIF, they have had instances where contractors in the assigned risk pool will pay \$100 for every \$100 of payroll. If you want to check to see if a contractor is currently covered by SAIF you can call (503) 373-8000. SAIF is authorized to release some information without a subpoena. They can tell us if a contractor is insured, how much the contractor has paid in insurance premiums, how many days were worked, and the amount of payroll reported. We can subpoena their audit reports, correspondence or any claims filed against a contractor.

### **State of Oregon - Worker's Compensation**

The Department of Insurance and Finance maintains a listing of employers who currently have worker's compensation as well as their coverage history. You can call the Employer Index at (503) 378-5540 to find out if any employer is currently covered, if they had coverage in prior years, and when their coverage was terminated. The Department of Insurance and Finance will only have information on employers who are required to have coverage. Employers are required to carry worker's compensation if they pay an employee \$200 per month.

Reforestation contractors frequently change their business names and the registrants of the business. There could be several reasons why the contractors change the business name or registrants, including attempts to circumvent payment of Worker's Compensation. In Oregon, wage payments made to the owners of the business, (that is, the partners in a partnership, or officers of a corporation) are exempt from worker's compensation coverage.

The Department of Insurance and Finance can tell you if an individual or a business is registered with them as a partnership, corporation, or a sole proprietor. This information may be helpful in determining whether or not all required returns were filed.

The files kept by the Department of Insurance and Finance are public records. However, the Department will not have a file on an employer unless there has been a complaint filed against him or her. If an employee makes a complaint against an employer, Worker's Compensation will send out a Field Investigator.

Worker's Compensation is not concerned about the subcontractor issue because they can hold the prime contractor liable. In fact, they can go back to any State agency or private company who offered the contract, if the prime contractor did not provide worker's compensation. This has been true since 1979. As of July 1989, Worker's Compensation can now go back to any entity who issued the contract with the exception of the Federal Government.

Oregon contractors working in Washington must carry Washington worker's compensation if: 1) the contract exceeds 30 days, or 2) they hire Washington residents.

### **State Regulatory and Licensing Offices**

The following is a list of state regulatory and licensing offices from which third party information can be obtained.

OREGON STATE

WASHINGTON STATE

1. Register Business/Incorporate/Assume Business Name:

Secretary of State  
Corporate Division  
158 12<sup>th</sup> Street, NE  
Salem, OR 97310-0210  
PH: (503) 378-4166

Dept. Licensing  
Services  
405 Black Lake Blvd.  
Olympia, WA 98504  
PH: (206) 753-4401

2. Tax Records:

Department of Revenue  
966 Central Street, NE  
Salem, OR 97301  
PH: (503) 945-8091

Department of Revenue  
Mail Stop AX-02  
Olympia, WA 98504  
PH: (206) 753-5525

3. Compensation Insurance:

Dept. of Insurance & Finance  
Worker's Compensation  
Division  
21 Labor & Industries Bldg.  
Salem, OR 97301  
PH: (503) 452-0288

Dept. of Labor &  
Industry  
905 Plum Street, SE  
Olympia, WA 98504  
PH: (206) 956-4817

4. Farm/Forest Labor Contractor License:

Bureau of Labor & Industry  
Wage & Hour Division  
Licensing Unit  
1400 SW 5<sup>th</sup>, Room 305  
Portland, OR 97201  
PH: (503) 731-4074

Dept. of Labor &  
Industry  
ESAC Division  
925 Plum Street, SE  
Olympia, WA  
PH: (206) 956-5315

State of Oregon  
Bureau of Labor and  
Industries  
3865 Wolverine, NE Rm. E-1  
Salem, OR 97303  
PH: (503) 378-3292

## **Bonding Requirements**

Contractors are required to provide bid bonds and performance bonds in certain instances. The bond can be either a surety bond underwritten by a bonding company or the individual can put up cash or other liquid assets such as stocks and securities. The cash or other liquid assets would be placed in an escrow account and would be available for payment of any unpaid wages due the employees. The interest income earned from the escrow account belongs to the contractor. The performance bond is held in escrow for 150 days after the job is complete. If no complaints are filed, the bond is released.

Currently, Federal agencies are only requiring bonding on service contracts and tree planting contracts over \$25,000. The State of Oregon requires a bid bond on all bids over \$15,000.

## **Laws Administered by U.S. Department of Labor**

The contractors are expected to comply with a number of laws that are administered by the Department of Labor in the performance of a Federal contract. The following is a brief explanation of the more common laws with which contractors are expected to comply during the performance of the contracts:

1. Service Contract Act of 1965, as amended: Wages Rates and Fringe Benefits for Service Employees.

This law is applicable to employees working on Federal contracts which are principally for services, as follows:

Contracts over \$2,500 -- Payment of not less than wage rates and fringe benefits found by the Department of Labor to be prevailing in the locality or, in certain cases, wages rates, and fringe benefits contained in a predecessor contractor's collective bargaining agreement as provided in a wage determination, included in the contract. This law also contains record keeping and safety and health requirements. Exhibit 2-2 contains a copy of a Wage Determination letter which is enclosed in each contract solicitation package.

Contracts of \$2,500 or less -- Payment of not less than the minimum wage provided in Section 6(a)(1) of the Fair Labor Standards Act.

Administered by: Employment Standards Administration, Wage-Hour Division (Safety and Health provisions are administered by the Occupational Safety and Health Administration (OSHA)).

2. Contact Work Hours and Safety Standards Act: Overtime Pay: Safety and Health Requirements.

This law and its implementing regulations require that all laborers and mechanics employed by contractors or subcontractors in the performance of most Federal service contracts exceeding \$2,500 be paid overtime compensation at a rate of not less than one and one-half times their basic rate of pay for all hours worked in excess of 40 in a work week. The act also includes safety and health provisions.

Administered by: Employment Standards Administration, Wage-Hour Division (Safety and Health provisions are administered by the Occupational Safety and Health Administration (OSHA)).

3. Migrant and Seasonal Agricultural Worker Protection Act: Labor Standards Protection for Migrant and Seasonal Agricultural Workers.

This law requires farm labor and forestry contractors, agricultural employers, and agricultural associations to observe certain labor standards when employing migrant and seasonal agricultural workers, unless exemptions apply. Only farm labor and forestry contractors are required to register with the Department of Labor. Worker protection includes: Vehicle and housing safety requirements; disclosure of wages, hours, and working conditions, maintenance of prescribed records; and itemized information concerning pay and withholding from earnings.

Administered by: Employment Standards Administration, Wage-Hour Division.

4. Federal Labor Law Enforcement: For information on any of the previously listed laws administered by the U.S. Department of Labor, you can contact the offices listed below:

PORTLAND AREA  
Department of Labor  
ESA, Wage-Hour Division  
540 New Federal Building  
1220 SW Third Avenue  
Portland, Oregon 97204  
PH: (503) 326-3052

SEATTLE AREA U.S.  
U.S. Department Labor  
ESA, Wage-Hour Division  
Room 1060  
Federal Office  
909 First Avenue  
Seattle, Washington  
PH: (206) 442-4482

## Chapter 3

### CONTRACTS IN GENERAL

#### MAILING LIST

Contractors wishing to secure reforestation contracts must submit their names to the Forest Service and the Bureau of Land Management to be placed on a mailing list. Once the contractors are on the mailing list they are notified of the contracts being offered to the general public. The Federal Government recommends that contractors subscribe to the "Commerce Business Daily" if they want notification of solicitations in excess of \$25,000, since this publication contains Government-wide procurement opportunities.

The Federal agencies maintain a separate mailing list used to notify the contractors of contracts under \$25,000 which are being offered. Contractors wishing to be notified of contracts under \$25,000 must submit their names to the local offices of each agency. To secure information on contracts under \$25,000, you will need to contact each of the Forest Service offices or BLM offices in your State.

The same is true with the State of Oregon Forest Service. General Services issues contracts in excess of \$15,000, and Contracting Officials are granted the authority to issue contracts under \$15,000. The State also maintains two separate mailing lists; one is maintained by General Services and the other is maintained by the Contracting Officials.

#### SOLICITATION METHODS

##### 1. Invitation for Bids (IFB)

A solicitation method which requires a prospective contractor to submit a sealed bid. The bids are then opened at a public bid opening. Bids are considered a firm offer and cannot simply be withdrawn after the opening. Contracts are awarded to the lowest bidder.

IFB is used for all solicitations in excess of \$25,000, and constitute the largest percentage of the contracts awarded.

##### 2. Request for Proposal (RFP)

A solicitation method used with competitive negotiation for procurement. If you are making an offer in response to a RFP, you may withdraw your offer at any

time before the contract is awarded. There is no public bid opening with this solicitation method.

RFP is normally used for solicitations under \$25,000. The Contracting Official will determine whether on not to use either a RFP or RFQ (below).

### 3. Request for Quotations (RFQ)

A solicitation method that includes a request for price information. An RFQ may be either oral or written. If written quotes are required, no public opening is held. Quotes are reviewed and awards are made based on the quote which will be most advantageous to the Government, the lowest bid.

## **CONTRACT CONTENTS**

The Federal agencies follow applicable Federal regulations when developing the schedules and general provisions of any pre-commercial thinning or tree planting contract. Therefore, you will find specific information contained within all contract solicitation packages. The following is a typical table of contents from a contract solicitation package:

Section A	_____	Solicitation, Offer and Award
Section B	_____	Continuation Sheet
Section C	_____	Specifications Tree Planting
Section D	_____	Inspection/Acceptance/Payment
Section E	_____	Inspection/Acceptance/Payment
Section F	_____	Delivery/Performance Tree Planting
Section G	_____	Contract Administration
Section H	_____	Special Contract Requirements
Section I	_____	Service Contract Clauses
*Section J	_____	Wage Determination and Fringe Benefits
*Section K	_____	Representations, Certifications, and Other Statements of Offerors
*Section L	_____	Instructions, Conditions, Notice to Offer

The sections marked with the "\*" will contain information that may be helpful in completing your audit. In these sections you will be able to find social security numbers, employer identification numbers, addresses, entity information, bonding company information, the taxpayer's average annual receipts for the prior 3 fiscal years, if applicable, and names, addresses, EIN, and labor license numbers of reported parent companies.



The Contract Officials may be able to provide you with more information on the contractor you have under audit which will be helpful in completing your audit. The following is a listing of information that can be obtained from Federal agencies and more than likely from State agencies, so check with them.

1. A listing of payments made on each contract.
2. The inspector's report listing the crew foreman and individuals working on the contract during the job site inspection.
3. The hourly rate, required by the Service Contract Act, payable to each employee.
4. A copy of the job bid submitted by the contractor, (in most cases).
5. A copy of the Government's estimate of the costs to complete the contract, (in most cases).
6. The Government's estimate of the number of employees needed to do the job and the hours needed to complete the contract.

The information retained by the Federal and State agencies can be obtained without a summons. However, you must supply the agency with as much information about the contracts as you can, (that is, contract number, the location of the contract, or the office that issued the contract). This is important because each Federal agency maintains only those records which pertain to the contracts they have awarded. To get the information on all the contracts worked by your contractor most likely will require contacting several different offices.

Probably the most important item that can be obtained from the Federal agency is a copy of the contractor's job bid. Remember that the job bid becomes the amount for which the contract is awarded -- that is, gross income received by the contractor. The job bid may also help you to determine if the costs reported on the return are reasonable.

### **DELIVERY/PERFORMANCE REQUIREMENTS**

Once a contract has been awarded, the Contract Officer Representative (COR) will issue the contractor a written notice to proceed. The contractor shall perform no preliminary work prior to receipt of the written notice to proceed. The contractor shall begin work within the specified number of days from the effective date of the notice to proceed. The contractor shall continue performance of the work according to the time specified within the Schedule of Items. Failure to do so may be cause for action under the "Default" clause.

At the pre-work conference, the contractor shall provide to the COR a written "work progress plan" which details his or her work force and his or her proposed schedule for completion of the work, within the contract performance time. The work schedule will be used as a guide to measure the contractor's performance as well as to calculate such things as the rate of tree delivery to meet the contractor's needs to ensure the timely completion of the contract. If the contractor's progress falls behind 20 percent of the established work schedule, the contractor's right to proceed may be terminated for default unless satisfactory progress is attained within 3 working days of the receipt of the written notice of deficient performance.

The COR is the on-the-ground administrator for the Contract Official. The COR is authorized to clarify technical requirements, and to review and approve work within the scope of the performance of the contract. The COR has the authority to designate a Project Inspector to determine whether or not the contractor has complied with the technical specifications, drawings, work schedule, and labor provisions at the work site.

At the pre-work conference, the Contract Official or the COR will make sure that each contractor understands, among other things, that the individuals performing the work are employees and are governed by statutory and regulatory laws pertaining to the reforestation industry. Some Contract Officials or CORs will have a special checksheet for the pre-work conference; you will find a copy of an actual checksheet used by a Contract Official, see Exhibit 3-1. This checksheet may be helpful in convincing the prime contractor that his or her workers are employees and do not qualify as subcontractors. Please refer to the employee section for further discussion of employees and laws applicable to the reforestation industry.

### **PAYMENTS**

All vendor payments of \$25,000 or more must be made through the Treasury Financial Communication System (a wire transfer system). Beginning sometime after December 31, 1988, and before December 31, 1989, contractors successful in obtaining contracts were required to supply certain financial institution information, (bank account numbers), to the Federal Government so their contract payments could be deposited directly to their bank account.

Contractors normally receive more than one payment during the performance time of the contract. According to Contract Officials, the contractors are paid approximately every 2 weeks and the amount of the payment is based on the work done, determined by the percentage of completion. However, it takes approximately a month from the time the contractor begins work on a contract until he or she receives the first payment.

Keep in mind, the duration of a contract is relatively short. In other words, once the contract is awarded it is usually started within 2 to 3 weeks and completed within another 2 to 4 weeks, depending on the size of the job. The Forest Service keeps the duration of the contracts short since they are concerned about planting the trees at a

time which will ensure the highest rate of survival among the new seedlings.

You may find that the contractor has deposited funds into his or her business account that he or she does not consider to be taxable. Reforestation contractors are able to secure advances from their bank by assigning the income from the contracts that they have been awarded. For a discussion on assignment of income see Chapter 6, of this audit guide.

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Checksheet Used by Contract Official

Prewrite Conference Guide (Service Contract)

PROJECT: \_\_\_\_\_ CONTRACT NO: \_\_\_\_\_

CONTRACTOR: \_\_\_\_\_ FOREST: \_\_\_\_\_

COR: \_\_\_\_\_ INSPECTOR \_\_\_\_\_

A prework conference was held at: \_\_\_\_\_  
and was attended by the following:

Forest Service:

Contractor:

\_\_\_\_\_ presided over the meeting and the following items were discussed:

FOREST SERVICE ORGANIZATION

A. General  
Only the Contracting Officer, the Administrative Contracting Officer (ACO), or Contracting Officer's Representative (COR) have authority with respect to this contract. Other Forest Service officials may visit the work site from time to time. However, the Contractor is warned that payment cannot be made for any costs incurred as a result of a response to an order or instruction issued by someone other than the Contracting Officer, ACO, or COR. The only exception to this is the case of a forest fire. While a direct line of communication is always open to the Contracting Officer, or ACO, all correspondence and other communications should normally be directed to the COR.

B. Contracting Officer  
The Contracting Officer has full authority for the administration of the contract and will personally handle all matters beyond the authority of the COR or ACO.

C. Administrative Contracting Officer  
An ACO has/has not been designated for the contract. The ACO is authorized to take all actions necessary for administration of the contract within applicable laws and regulations, except for final decisions under the Disputes Clause, termination for default or convenience, and final acceptance of the services rendered. This includes signatory authority for Contract Modifications up to the limits stated in the letter of designation.

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D. Contracting Officer's Representative

The COR is the on site contract administrator for the Contracting Officer, whose duties and responsibilities are defined in the letter of designation. Generally, this includes fill authority for the day-to-day administration of the contract, except for matters pertaining to changes in contract price and time.

E. Inspector(s)

The COR may designate Inspectors who are responsible for checking Contractor's compliance with the technical specifications, work schedule, and labor standards of the contract. Contractor will receive a copy of Inspector Designation Letter(s). Copies will be/were distributed.

PERFORMANCE

F. Contract Time

Contract time specified for this project is \_\_\_\_\_ calendar days. Contract time will be accounted for on a calendar day basis, including Saturdays, Sundays, and holidays, and will run continuously from the effective date of the Notice to Proceed to the date of completion of the work, unless work is suspended by the COR. Work suspension may be partial or total. Normally, the count of contract time will cease when work is totally suspended. During period of partial suspension, count of contract time will continue, however, an appropriate adjustment will be made in the contract time. Notice to Proceed was/will be effective \_\_\_\_\_.

G. Progress Schedule

A Proposed Progress Schedule, showing the proposed sequence of work and the anticipated date of completion, was prepared on form R6-6320-18 and copies were distributed/are attached:

or,

The COR and Contractor agreed to use a daily rate of production using the following formula in lieu of preparing form R6-6320-18:

$$\frac{\text{Total Contract Units}}{\text{Total Contract Days}} = \text{Units Daily Production}$$

Daily Production shall be \_\_\_\_\_ units (acres, miles, etc.)

ADMINISTRATION

H. Superintendence

In the absence of the contractor, there shall be an authorized representative of the Contractor on the project at all times when work is in progress. Contractor submitted letter designating representative(s), and the extent of his/her/their authority. Copies were distributed/are attached.

I. Permits and Responsibilities for the Work

The Contractor is responsible for obtaining any applicable licenses and permits and must comply with all Federal, State, and local regulations, laws and codes.

J. Camping Permits

The Contractor does/does not intend to camp on National Forest lands. Forest Service permits will specify restrictions regarding campsites and sanitary provisions. Combustible refuse, resulting from lunches, etc., may be burned if authorized by District Ranger. All noncombustible materials, cans bottles, etc., shall be removed from Forest land.

K. Payments

Progress payments will be made monthly as the work proceeds, or at more frequent intervals, if approved by the Contracting Officer. Progress payments will be initiated by the COR on the \_\_\_\_\_ day of each month.

Following completion and acceptance of the work, the Contractor shall be paid upon presentation of a properly executed voucher and a release of all claims against the Government, other than claims in stated amounts specifically excepted by the Contractor on the release form.

L. Fire Prevention and Control

Specific fire prevention measures were briefly/thoroughly discussed including fire period, precautionary measures, and fire tools. The COR is responsible for obtaining any fire requirement waivers, authorized by the District Ranger.

CONTRACT CLAUSES

M. Changes

The Contracting Officer may, by written Change Order, make any change within the general scope of the contract, including but not limited to: changes in specifications; in method or manner of performance of the work; in Government-furnished facilities, equipment, materials, services or site; and direct acceleration in the performance of the work.

N. Disputes

This clause prescribed definite procedures to be followed in cases of disputes arising between the Contractor and the Government. Except as the parties may otherwise agree, pending final resolution of a claim, the Contractor shall proceed diligently with the performance of the contract and in accordance with the Contracting Officer's decision.

O. Termination for Default; Damages for Delay; Time Extensions

If the Contractor refuses or fails to prosecute the work with such diligence as will ensure completion within the time specified, the Government may terminate the Contractor's right to proceed. Whether or not the Contractor's right to proceed is terminated, the Contractor shall be liable for any damage to the Government resulting from the refusal or failure to complete the work within the specified time,

P. Property and Personal Damages

The Contractor shall use every precaution necessary to prevent damage to public and private property. The Contractor shall be responsible for all damage to property and persons that occur as a result of his/her or his/her agent's or employee's fault or negligence.

LABOR STANDARDS PROVISIONS (Statutory and regulatory requirements pertaining to labor)

Q. Equal Opportunity

The Contractor agrees that he/she will not discriminate against any employee or applicant for employment because of race, color, religion, sex or national origin and will take affirmative action to ensure that applicants are employed, and are treated during employment, without regard to race, color, religion, sex or national origin.

In the event of noncompliance with the Equal Opportunity provisions, the contract may be canceled, terminated or suspended, in whole or in part, and the Contractor may be declared ineligible for further Government contracts. The Contractor must include the Equal Opportunity provisions in every subcontract. The Equal Employment Opportunity Poster will be/was given to the Contractor, with instructions to post in conspicuous places, available to all employees and applicants for employment.

R. Service Contract Act of 1965

All service employees employed in the performance of the contract shall be paid not less than the minimum monetary wage and shall be furnished fringe benefits in accordance with the Wage Determination Decision.

The Wage Determination Decision, along with the Wage Rate Poster WH-1313, Notice to Employees working on Government Contracts, shall be posted in a location where it may be seen by all employees performing on the contract.

The Contractor shall make and maintain, for three years from completion of the work, records of each employee's name, address, work classification, wages paid and fringe benefits provided, hours worked and any deductions from compensation.

S. Contract Work Hours and Safety Standards Act

Laborers, mechanics, apprentices, trainees, watchpersons and guards shall be paid at least one and one-half times their basic rate of pay for all hours worked in excess of 8 hours a day or 40 hours a week, whichever is the greater number of overtime hours.

T. Safety and Sanitary Working Conditions

The Contractor shall not permit the services called for by the contract to be performed in surroundings or under working conditions, under the Contractor's control, which are unsanitary or hazardous or dangerous to the health or safety of employees engaged in the work. The Safety and Health Protection on the Job poster was given to the Contractor with instructions to post at the work site.



U. Federal Procurement Regulations

- 1. Part I, Section C of the contract contains both the general and technical specifications.
- 2. Part I, Section E deals with inspection and acceptance. Of special note is Clause 52.246-4, Inspection of Services, Fixed Price. This clause provides, among other things, that the contractor will provide and maintain an inspection system and records acceptable to the Government covering services under this contract.
- 3. Part I, Section H contains special contract requirements.
- 4. Part I, Section I contains clauses incorporated by reference. The full text is available in the Federal Register. Complete copies can be purchased from the Superintendent of Documents, Government Printing Offices, Washington, DC 20402. All applicable referenced clauses are a part of this contract.

Other Items Discussed

The specifications and inspection procedures of this contract were jointly reviewed by the Contractor and the COR.

\_\_\_\_\_ Date \_\_\_\_\_

\_\_\_\_\_ Date \_\_\_\_\_

(Contracting Officer's Representative)

EXPERIENCE QUESTIONNAIRE

1. How many years experience as a Prime Contractor do you have? If this is your first contract as a Prime Contractor, what experience have you had either as a subcontractor or employee?

2. List your recent contract experience relating to reforestation?

Contract Amt	Type of Project	Date Completed	Contact Person
--------------	-----------------	----------------	----------------

3. What contracts do you currently have?

4. How many personnel will be assigned to this project?

a. Who will be your forperson(s) and what is their experience?

b. Who will be responsible for self-inspection and what are their qualifications?

5. In the event you fail to meet progress, how will you correct this problem?

6. Are there any problems you may foresee with this contract? If so, explain.

7. Are you aware of the applicable Service Contract Act wage rate for this contract?

8. Have you ever defaulted on a reforestation project? If so, explain.

9. Did you visit the job site or talk with anyone regarding the project?

10. A copy of the bid abstract listing the awarded contractors has been sent to the State of Oregon's Workmen's Compensation Bureau and U.S. Department of Immigration. You may be contacted by them

\_\_\_\_\_  
Contractor

\_\_\_\_\_  
Title

\_\_\_\_\_  
Solicitation No.

\_\_\_\_\_  
Contract No.

\_\_\_\_\_  
Date

## Chapter 4

### PRE-AUDIT ANALYSIS

#### ANALYSIS OF INFORMATION ACCUMULATED BEFORE STARTING THE AUDIT

Returns assigned to you will normally contain, at the most, charge-out labels, a transcript, and an IRP transcript. When you are assigned a reforestation contractor and the case file does not contain an IRP transcript, order one as soon as possible. You may find that the contractor has several sources of income that he or she has failed to report. However, do not use the IRP document as your only income probe since it is most likely that this document is only partially complete at best. Hopefully, the following discussion of the IRP transcript will give you a better understanding of the Form 1099 reporting problems of this industry.

#### IRP Transcripts

"Income" is the audit issue which benefits most from accumulating the types of information/documents that are discussed in this chapter. Most commonly, an examiner has little information in the file before the first appointment with the taxpayer. Items that have been accumulated at this stage of the audit are those that have been generated by the Service Center. Of these, only the IRP transcript has the potential of assisting in the income audit but, as known by most examiners, these documents rarely give a complete listing of an entity's taxable sources of income. However, the IRP transcripts are a good starting point in the income audit.

We found three major problems with how the Federal agencies were handling the filing of their Forms 1099. First, the Federal employees were not sure who should receive a Form 1099; one agency reported that they were not issuing Forms 1099 to partnerships. Secondly, the Federal agencies issuing the contracts were not assuming responsibility to see that a Form 1099 was issued. The Form 1099 was only issued if the proper box was indicated on the payment voucher by the individual requesting the payment. Finally, there was a question as to who was responsible for seeing that the taxpayer identification numbers (TIN's) were provided. According to the company who issued the check, if the identification number was not included on the payment voucher, then a Form 1099 would not be issued for that payment.

Whether or not the Forms 1099 are complete is only one of the problems. The second identified problem is whether or not the Form 1099 is correct. During our examination of one reforestation contractor, we found that he issued 35 Forms 1099. Of the Forms 1099 issued, we found that: 1) Nine Forms 1099 matched the name and SSN shown on AIMS and 2) 26 of the Forms 1099 had either the wrong SSN or no data was available on AIMS. The group researched Forms 1099 filed by two other

contractors and found that some contractors appear to be filing erroneous Forms 1099 to circumvent the Form 1099 matching program. Even though the Forms 1099 may not be 100 percent correct, they are very useful and may identify sources of income which cannot be found using other audit procedures. For example, a contractor's accountant did a bank deposit analysis to determine his income. The bank deposit analysis appeared to be complete and show .all sources of income. However, after receiving an IRP transcript we were able to identify income received from unreported sources which were not deposited by the contractor.

## **DOCUMENT REQUEST**

### 1. Request the normal documents

At a minimum, the following should be requested: All books and records, adjusting journal entries, accountant's workpapers, bank statements for business and personal accounts, savings account and credit line statements, duplicate deposit slips, a detailed depreciation schedule, Forms 1099 received, Forms W-2 and 1099 filed by the contractor, copies of employment tax returns (beginning with the year under audit to the most current returns filed), and copies of invoices retained.

### 2. Request additional documents

- a. Request the prior and subsequent year returns. A comparative analysis is helpful in identifying large or unusual items.
- b. Request a listing of all contracts worked by the taxpayer during the year and a listing of the contracts in progress at yearend.
- c. Request a tour of the business. This may be the only time you will be able to inspect the business premise in order to determine if the assets claimed on the return exist and are reasonable.
- d. Request that the initial interview be held when the taxpayer(s) can be present. The initial interview may be the only time that you will be able to talk to the taxpayer.

During your pre-audit you may find other items that appear to be unreasonable. Be sure to include these items on the document request. Remember that it is important to make the document request as complete as possible since it becomes increasingly harder to get documents as the audit progresses.

## **Chapter 5**

### **INTERVIEW**

#### **IMPORTANCE OF THE INTERVIEW**

All techniques in this Guide were tested in actual contractor cases. The process of developing a detailed, specific interview plan was found to be a necessity at the inception of each audit. Sometimes follow-up interviews were needed, as taxpayers altered their testimony when confronted with examination findings.

The quality of your initial observations and questioning will affect the overall quality and success of the entire examination, whether or not you have developed third party information or noted other items indicative of non-compliance in your precontact analysis of the returns.

#### **REVIEW OF THE BASIC TECHNIQUES**

The purpose of your interview is to secure from the taxpayer a general financial picture and familiarize yourself with the business operations and recordkeeping practices.

Planning is essential to the success of the interview. The interview should be planned in advance, keeping in mind your objectives and the results of your pre-contact analysis and your understanding of how this industry should work. If a questionnaire is used, it should be written specifically for the case in hand. The completed document should be a flexible guideline that will assist but not restrict your interview.

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

The questions you ask should generally enable you to obtain the background of the taxpayer and his or her business, to familiarize yourself with the business operation, to understand the accounting system, to fix responsibility for the records, and to identify sources of income.

## **GUIDELINE FOR INTERVIEWING THE CONTRACTORS**

When interviewing reforestation contractors, specific emphasis should be given to the areas where non-compliance has proven to be the highest and to those which may, at a later date, be presented as a defense against understatement of income. Since it is not uncommon to find that some contractors have little or no fluency in English, it is important to determine if the assistance of an interpreter will be required or available prior to the initial appointment.

The understatement of income and failure to pay employment taxes are the primary, but by no means the only, areas of adjustment on the contractors' returns. Defenses against the understatement of income can be cash hordes, loans, or gifts in the case of non-specific understatement, misunderstanding or poor communication with the return preparer; these are the more common in specific understatements.

A partial list of items you may wish to incorporate in your interview plan are given below. The particular circumstances of an individual case, including data accumulated prior to the interview, will suggest alterations and additions. It is not intended for use as a pro forma.

### **SUGGESTED QUESTIONS**

#### **Business Operations:**

1. How long have you been in the reforestation business?
2. How did you get started in the business?
3. Have you operated at other locations or under another assumed business names? If so, where and what other names?
4. Are you a prime contractor or a subcontractor?
5. Who did you work for in the audit years, Federal/state agencies, private companies, or other contractors? List.
6. What types of contracts did you complete: Thinning or tree planting? Other?
7. Describe the method you use to determine how much you will bid on any given contract.
  - a. What type of expenses are included in your job bid?
  - b. How much profit do you expect to make on a contract?
8. Where there any months that you did not work? When?
9. Are you required to supply transportation for workers?
10. What tools do you supply for the workers?
11. How are you paid for the work that you do?

### **Income:**

1. Do you have a credit line? If so, are income checks deposited to this account?
2. Did you assign any Forest Service contracts to a bank or to a credit line account? Identify the account.

### **Accounting Records:**

1. What accounting method is used (that is, cash or accrual)?
2. Who kept the books and records in this year?
3. What books are maintained?
4. What other kinds of records are kept -- that is, time cards, duplicate deposit slips, cost sheets?
5. How and when is income recorded? Who records it and when?
6. Who makes the deposits?
7. Is all income deposited? In which accounts do you deposit income checks?
8. Are expenses paid by check or cash?
  - a. What type of expenses are paid with cash?
  - b. What records are maintained for payments made in cash?
9. What is your bill payment policy?
10. What records are supplied to the bookkeeper or preparer by the taxpayer?

### **Employee versus Subcontractors:**

1. Are all wages included on the tax return?
2. Do you pay wages in cash? Are cash wages reported on the employment tax returns? Were Forms W-2 or 1099 issued for all labor including cash wages? Did you subcontract any of your contracts in this year?
3. Describe what type of work is done by your employees? Do the subcontractors have any other duties?
4. Name all subcontractors used during the audit year?
5. Do the subcontractors have DBA's? What are they?
6. Do you have written agreements with the subcontractors?
7. How much do you pay the subcontractors? How is this amount determined?
8. Are the subcontractors reimbursed for any expenses? What for? How much? How are reimbursements accounted for?
9. Do you issue Forms 1099 to all subcontractors?
10. Do all your subcontractors have a Farm Labor License?
11. Did the subcontractors work for others during this year?
12. Do the subcontractors supply the tools for the workers?
13. Do you supply transportation for the subcontractors?

### **Touring the Premises:**

- A tour of the business premises may not give you all the answers that you will need later, but it more than likely will give you a good idea of the taxpayer's business operations. In addition, by requesting the tour of the business you may get the opportunity to talk to the taxpayer, which may not be available to you in the future. During the tour of the business you will need to look for the following types of items:
  1. If the taxpayer has numerous vehicles on the depreciation schedule, does he or she have a place to park them at night? There could be personal expenses on the vehicles.
  2. Are there employees' cars parked at the premises during the day?
  3. Does the taxpayer have power saws on the business premises?
  4. Does the taxpayer have a building on the depreciation schedule? If so, what is its use?



## Chapter 6

### ACCOUNTING RECORDS

#### ACCOUNTING RECORDS IN GENERAL

Reforestation contractors' accounting records can come in any number of forms (that is, boxes with no audit trail to double-entry systems). Therefore, the examiner should be prepared to deal with a variety of different accounting systems. It is not uncommon to find poor bookkeeping and recordkeeping practices among prime contractors as well as subcontractors. You can expect to find situations where ledgers don't balance, journal columns don't foot, invoices can't be found, and personal amounts are deducted as business expenses.

The majority of reforestation contractors operate as sole proprietors and keep their books and records on a calendar year basis. Lack of internal control seems to be a common element among the reforestation contractors. The contractors frequently are family-controlled businesses with one family member performing the duties of keeping the books and records as well as recording income.

We have found that reforestation contractors use either the cash or accrual method of accounting. This guide is not meant to explain the various methods of accounting used in the reforestation industry, but rather to assist the examiner in determining what to look for under the various methods described.

#### CASH METHOD OF ACCOUNTING

The cash method of accounting is used by most reforestation contractors. When examining a contractor on the cash basis, secure a listing of the contracts worked during the year. The list should include the contract number, the locations where the work was done, and the amounts and dates of the payments received during the year. In addition, request a list of contracts in process at the end of the year. Compare this list to the bank deposits to determine if all money received was deposited upon receipt -- this step will disclose if the contractor has postponed depositing receipts until after the end of the year or if the contractor's deposit reflects that he or she has taken cash and deposited the remainder.

Generally, cash-basis contractors use their bank deposits to determine total income. However, examination results revealed that it is common for contractors to cash income checks without depositing the income. In other instances, we found that the contractors deposited large amounts of cash for which they had no records. The high potential for large amounts of unreported income allows the examiner an opportunity to develop quality fraud referrals.

Question the contractor at the initial interview and determine which method was used to determine gross receipts reported on the tax return. It is important to secure as much information as possible early in the examination since the contractor may not be willing to supply information as the audit progresses.

Also be aware that reforestation contractors, as a normal practice, are able to assign income to their bank. The bank will advance funds (usually 80 percent of the contract award letter) to the contractor. The bank then becomes the consignee and the Forest Service or BLM makes the checks payable to the bank. The bank normally receives the checks, pays off the outstanding loans, and deposits the remainder to the contractor's business account.

Examinations of cash-basis contractors also reflected frequent adjustments for their deducting items on their returns for which they have no documentation. Within the reforestation industry it is common practice for the contractors to use cash to pay business expenses. The contractors are often unable to supply proper documentation for the cash payments. According to the Bureau of Labor and Industries, the contractors use cash to pay their workers. We have found at least two reasons to explain why the contractors use cash to pay wages:

1. Illegal aliens perform much of the labor in this industry and they want to be paid with cash since they do not have Social Security Numbers to obtain bank accounts, and
2. Contractors want to avoid paying worker's compensation premiums and employment taxes on wages paid.

### **ACCRUAL METHOD OF ACCOUNTING**

Occasionally you will encounter contractors who are using the accrual method of accounting. If you find contractors who are using the accrual method of accounting, you will need to find out why they are using this method and when they adopted this method. You will want to know if they were required to apply to the Commissioner of the Internal Revenue to change to this method of accounting. Cash-basis contractors are not allowed to switch to the accrual method without applying for a change of accounting method.

There appear to be few tax advantages or other reasons for reforestation contractors to use the accrual method of accounting, with the exception of a corporation who has a valid business reason for a yearend other than December 31. The reforestation industry is seasonal, which means that the contractors do not have employees working during every month of the year. There are some months of the year when weather conditions do not allow the contractors to have crews in the woods. The weather

conditions during the month of December usually prevent contractors from working. Therefore, the contractor's accrued expenses should be minimal in December since wage expenses and the related employment taxes are the contractor's single largest expense (that is, between 50 and 60 percent of gross income). We have also found that the Small Business Administration requires their contractors to file quarterly financial statements; these financial statements are to be prepared using the accrual method of accounting. Therefore, you may find these Section 8A contractors using the accrual method of accounting for tax purposes. Make sure the contractors have a valid election since it is likely that the election was not made.

Inspect accounts payable at the end of the year to determine if the taxpayer has properly accrued expenses and that the expenses are deductible per IRC section 162.

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## **Chapter 7**

### **EMPLOYMENT TAXES**

#### **EMPLOYEES IN GENERAL**

All Federal contracts contain a section that discusses the Contract Service Act and its requirements. Information about the Contract Service Act is normally found in Section J of the solicitation package. Within this section, there will be a Wage Determination Letter issued by the U.S. Department of Labor, Wage and Hour Division. The Wage Determination Letter lists the class of service employees, minimum hourly wage rates, and fringe benefit payments required to be paid to each employee.

Under the Contract Service Act, employers are required to treat each individual working in the industry as an employee. The only exception is payments made to valid subcontractors. If the prime contractor pays a subcontractor to complete the job, the subcontractor becomes responsible for paying wages and employment taxes. The payments made to the subcontractors should be large since the subcontractor must pay employee wages, worker's compensation, and the related employment taxes etc.

Subcontractors must follow the same State and Federal law as the prime contractors. To be a valid subcontractor, they must provide the following:

1. A valid Farm/Labor Contractor's License (applies in Oregon; check to see if there are similar requirements in your state).
2. Verification of Worker's Compensation coverage.
3. Proof that they work for more than one prime contractor.

As previously stated, the Contract Official (COR) will discuss the Contract Service Act with the contractor during the pre-work conference. They will discuss the contract requirements for the size of crew to be provided by the contractor; the crew size may be only three people, but a normal crew size ranges from 5 to 12 employees. It is not uncommon for a contractor to have more than one crew working at a time. Keep this in mind if a contractor tells you that it is industry practice for contractors to employ only subcontractors.

#### **ISSUES GENERALLY ENCOUNTERED**

An examination of a reforestation contractor can result in large employment tax adjustments. It is common to find wages being paid without consideration of

employment or income tax withholding. To stay competitive in this industry, the contractors are looking for ways to pay less in wages, employment taxes and worker's compensation premiums. The contractors are keeping gross wages as small as possible which reduces both their employment tax liabilities and their worker's compensation premiums. Remember that both employment taxes and worker's compensation premiums are determined based on total wages paid.

The reforestation industry is labor intensive which means that labor costs and the related employment taxes represent the bulk of the contractor's expenses. Adjustments made in this area can generate substantial tax liabilities. The most common adjustments are reclassification of subcontractors to employees and setting up additional compensation payments to already existing employees. Substantial taxes will be generated since the wages paid to individuals seldom exceed FICA and even FUTA maximums due to the mobility of the work force. The group has found that it is not uncommon to have employment tax liabilities exceed 40 percent of additional gross wages before the application of failure to deposit, negligence, or fraud penalties. During our examinations of reforestation contractors the group has identified the following as possible issue areas:

1. The contractors report all payments to individuals as non-employee compensation payments (subcontractor payments).
2. The contractors pay their workers in cash and deduct the payments as ordinary and necessary business expenses, not wages.
3. The contractors deduct the payment of personal expenses for the employees as other business expenses, not as wages.
4. The contractors do not file Forms W-2 or 1099 with the Internal Revenue Service.

### **Subcontractor Payments**

We are finding that the majority of the prime contractors are reporting only subcontractor payments. If the contractor has only subcontractors then they would not be liable for either FICA or FUTA taxes. However, this is usually not the case. We have found that the prime contractors normally have some employees and some subcontractors.

When auditing the employee versus subcontractor issue, you need to secure certain information from the contractors. First, secure a listing of the individuals who received non-employee compensation payments during the examination year. The group found it was easier to create a data base from the contractor's canceled checks

rather than trying to get this information from the contractor. The data base gave us the ability to accumulate payments by payee and determine when the payments were received and how much was received by each individual.

Next, question the contractor on the work performed by each individual. Start with the suggested questions outlined in Chapter 3, of this Guide and add other questions that are relevant. Refer to the training materials “Independent Contractor or Employee?” Training 3320-102 (Rev 10-96) TPDS 84238I.

Our revenue officer examiner was successful in reclassifying subcontractor payments to employee wages. The revenue officer examiner relied heavily on whether or not the subcontractor held a valid Farm/Labor Contractor's License (for additional information on the .Farm Labor License, refer to Chapter 2). Since Oregon may be the only state that requires a license, you may wish to contact the Forest Service or Bureau of Land Management to obtain additional information on whether or not the individuals receiving subcontractor payments are valid subcontractors.

If you determine that a reclassification issue exists, you will want to first determine if the taxpayer has an IRC section 530 safe haven. If the taxpayer does not have an IRC section 530 safe haven, then you will need to consider whether or not the taxpayer is allowed the relief provisions of IRC section 3509.

If the taxpayer has not filed returns, you will need to give proper consideration to the use of either Delinquent Return or Substitute for Return procedures which are discussed below.

**Delinquent or Substitute for Return:** If the contractor has not filed employment tax returns and you make the determination that a portion of the subcontractor payments are, in fact, employee wages, you will need to follow either the Delinquent or Substitute for Return procedures.

When it has been determined that the contractors are required to file employment tax returns but do not have an EIN, you will need to secure a EIN before you can close the case. An EIN can be quickly obtained from the Service Center by using the following procedure.

#### Securing an Employer's Identification Number (EIN):

If the employer does not have an EIN, the examiner should assist in securing one. The following procedure will allow the examiner to secure a number quickly:

1. Form SS-4 should be prepared for the employer.

2. Call the Service Center servicing your District.
  - a. The Service Center will ask for information directly off the prepared Form SS-4.
  - b. In the upper-left corner of the completed Form SS-4, type the newly assigned EIN number and an ID number that will be given to you by the Service Center.
  - c. Mail the completed Form SS-4 to the Service Center servicing your district within 5 days from the time the new EIN number has been

### **Cash Wages Deducted on the Return**

Deductions for cash wages may be identified on the return as labor under cost of goods sold, as contract labor, or commissions. If wage expense has been increased by cash wages paid, the issue will become apparent when you reconcile payroll. Requesting employment tax return transcripts, prior to beginning the examination will help you determine if employment taxes are being filed and will show FICA wages reported by the contractor.

Deductions for cash wages may be combined with other business expenses. It may not be easy to identify whether or not the contractors are deducting wages paid in cash since the contractors do not maintain adequate books and records. Therefore, if you do not identify this issue during the pre-audit of the return, be sure to include questions about cash payments in the initial interview. Ask the contractors if they ever use cash to pay business expenses, find out what types of expenses are paid by cash, and ask the contractors if they pay employees in cash. This information will be useful as the audit progresses.

### **Unsubstantiated Cash Expenses**

The group has found that, within this industry, dealing in cash is common while retaining receipts seems to be uncommon. Since it is very difficult to disallow all unsubstantiated expenses you need to determine if the contractor's testimony (from the initial interview or later interviews) is corroborated by the documents you have been given. The contractor's receipts should support the contractor's need to deal in cash. For example, the contractors report that cash is needed by their foremen to purchase gas and food for the employees when they are in remote forest areas. The receipts should be for gas and food that has been purchased outside of the contractor's home town. The group found contractors giving the following explanations to substantiate the use of cash:



## 1. Checks Issued to the Foreman or to Cash

As previously mentioned, contractors may be deducting checks issued to their foremen or to cash as other business expenses, (that is, auto expenses, etc.). The contractor's defense is that the reforestation industry is cash intensive. They report that their foremen need cash to manage the workers while in remote forest areas. According to the contractors, the foremen are unable to cash personal checks and they do not have credit cards to purchase food or gas or to pay lodging for the workers. To determine if the contractor's testimony is consistent with the records, you will want to ask to see the employee reimbursement vouchers. The contractor must pay such benefits pursuant to an "accountable plan" as defined in the regulations issued under IRC section 62(C); otherwise the advances/reimbursements must be included on the employee's Form W-2. Note that substantiation is required by IRC section 274(d).

If you suspect that the contractor is paying wages in cash, be sure to ask the contractor for copies of his or her job bids. You will be able to use the job bids to develop a percentage (wages as a percentage of gross income) to compare to the return. If the percentage of wages per the return is less than the amounts reported on the job bids then the contractor most likely is paying wages in cash. You will also want to request the payroll records and compare the hourly rate per the payroll to the hourly rate per the job bids, looking for differences.

If the contractor does not provide adequate substantiation for either employee reimbursements or cash expenditures and if receipts do not agree with oral testimony, the unsubstantiated expense may be disallowed under IRC section 162. However, if you have sufficient facts to indicate that wages were paid in cash, an alternative position is to allow the payments as wage expense under IRC section 162 and set up the related employment tax liabilities.

## 2. Payment of Expenses for Employees

Sometimes the contractors may be including items paid on behalf of their employees as ordinary and necessary business expenses. For example, the contractor may be paying employees' apartment rent or buying their gas, clothing, or groceries. The contractor's defense is that he or she must provide for his or her employees since the workers are nonresident aliens or that it is a requirement of their job.

These employer-provided items are "fringe benefits." A fringe benefit is any property or service (or cash under certain circumstances) that an employee receives from his or her employer in lieu of or in addition to regular taxable wages. If a benefit is not specifically excluded from gross income by the Code (for

example, IRC sections 105, 106, 107, 117(d), 119, 120, 125, 127, 129, and 132), its value must be treated as compensation and reported as wages on the employee's Form W-2.

Under IRC section 119, an employee may exclude from gross income the value of any meals or lodging furnished in kind to the employee by or on behalf of the employer for the convenience of the employer, provided that certain requirements are met. Meals must be furnished on the business premises of the employer, and, in the case of lodging, the employee must accept lodging on the business premises of the employer as a condition of employment. IRC section 119 does not permit an employee to exclude from gross income cash the employer gives the employee to purchase meals or lodging.

Amounts paid for an employee's meals, lodging, or gasoline may be excluded from the employee's income to the extent the amounts are reimbursements or allowances for travel expenses incurred by the employee while "away from home" and are paid under an accountable plan as described in the regulations under IRC section 62(c). In general, a reimbursement or other expense allowance arrangement is an accountable plan if the requirements of business connection, timely substantiation, and timely return of amounts in excess of expenses are satisfied.

In general, an arrangement that provides advances, allowance, or reimbursements for business expenses paid or incurred by the employee in connection with performing services as an employee of the employer and that are deductible under IRC section 162 will satisfy the business connection requirement<sup>1</sup>. If amounts are provided for expenses that are not deductible under IRC section 162, the business connection requirement is not satisfied. For example, travel expenses are deductible only if the employee is "away from home." Accordingly, it is important to establish whether the employees are, in fact, away from home for tax purposes. Copies of the contract award letters will probably give you the job locations. You should be able to match the cash receipts by date and location to the contract award letters.

If an arrangement is not an accountable plan, all amounts paid thereunder are treated as paid under a nonaccountable plan, are required to be reported on the employee's Form W-2, and are wages for purposes of withholding and payment of employment taxes.

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<sup>1</sup> The regulations under section 62 of the Code provide that an arrangement will satisfy the business connection requirement if reimbursements or allowances are provided for expenses that are deductible under sections 161 through 196 of the Code. In the reforestation industry, these expenses are deductible solely under section 162 of the Code.

Employer-provided clothing may be excluded from the employee's gross income as a working condition fringe benefit under IRC section 132(d) provided the clothing is a special item required in the employee's work that does not replace items of ordinary clothing. Examples of such items include work shoes or special gloves, and a "uniform" that is required as a condition of employment and that is not adaptable to general wear. An employer may provide a working condition fringe benefit in cash, provided that the employee verifies that the payment was actually used for the intended expense and any excess cash is returned to the employer.

Any of an employee's personal, living, or family expenses, such as travel that is not away from home, that are paid for or provided in kind by the employer must be included in the employee's income and reported on Form W-2. See IRC section 262.

To determine whether a fringe benefit furnished to an employee is wages for employment tax purposes, look at the definitions of wages and the exclusions therefrom which are found in IRC section 3121(a) for FICA purposes, IRC section 3306(b) for FUTA purposes, and IRC section 3401(a) for income tax withholding.

### 3. Payments to Nonresident Aliens

In general, if you pay wages to nonresident aliens, you must withhold income tax (unless excepted by regulations) and Social Security taxes as you would for a U.S. citizen. The wages are subject to FICA and FUTA taxes. Nonresident aliens can be exempted from "wages" under a U.S. treaty provision, if the alien is lawfully admitted into the United States to do agricultural labor. Tree planters and tree thinners are not considered to be agriculture workers and, therefore, are not exempted from FICA or FUTA.

Contractors may report that they are paying the expenses of the nonresident aliens brought to the United States to plant trees. Again these payments are considered to be additional compensation to an already existing employee unless IRC section 119 applies.

Employees temporarily admitted into the United States to do agricultural work are exempt from FICA and FUTA provided they are admitted to the United States under the H-2 Visa program. Under the H-2 Visa program, the employer is responsible to secure a visa, provide transportation for the workers both to and from Mexico, as well as house the nonresident aliens while they are working in the United States. Immigration (INS) should be contacted to determine if, to whom, and how many H-2 Visas have been given out in your State.