



Market Segment Specialization Program



Drywallers

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DRYWALLERS

TABLE OF CONTENTS

	<u>Page No.</u>
Chapter 1, Introduction	
Purpose	1-1
Overview	1-1
Chapter 2, Industry Background	
Industry Practices	2-1
Industry Participants and Considerations	2-2
Chapter 3, Industry Issues and Audit Techniques	
Preplan and Issue Identification	3-1
Pre-Audit -- In General	3-2
Pre-Audit -- Corporations	3-3
Pre-Audit -- Conclusion	3-3
Initial Interview	3-4
Employment Tax	3-5
Required Filing Checks	3-6
Reconciliation of Books to Return.	3-6
Examining Source Documents.	3-7
Job Files	3-7

Contracts with Owners/General Contractors	3-8
Bids and Estimates	3-9
Materials and Other Expense Invoices	3-9
Progress Billing Invoices	3-9
Correspondence	3-10
Contracts with Subcontractors	3-10
Billings from Subcontractors	3-10
Third Party Contacts	3-10
Bad Debts	3-11
Unreported Income	3-11
Glossary	G-1
Appendix A, Sample Initial Interview Questionnaire	A-1

Chapter 1

INTRODUCTION

PURPOSE

This audit technique guide is a supplement to the MSSP Construction Industry Guide. This guide addresses drywallers in their usual capacity of doing work as subcontractors and explains construction audit techniques in this context. Examiners should be familiar with the items shown in the Table of Contents of the MSSP Construction Industry Guide. Items that pertain to drywallers, such as employment tax issues, the cash to accrual accounting change issue are referenced therein. A familiarity with other items on the MSSP Construction Industry Guide Table of Contents is recommended so that examiners can identify and develop issues outside of the scope of this guide.

This guide addresses specific aspects of the drywall contractor's business to provide a starting point for conducting audits of drywall contractors. This guide incorporates material from Internal Revenue Manual (IRM) 4231, Chapter 670 "Examination Techniques Peculiar to Small Businesses."

OVERVIEW

Drywallers install wallboard onto framing and then finish the wall surface so that it is ready for painting, wallpapering, etc. These basic skills are performed by different business entities encompassing various work relationships. Many perform such work as specialty contractors in residential and commercial construction, entering into contracts with general contractors. Drywall contractors made up 2 percent of the total number of Construction-Specialty Trade Contractors in 1991 according to "American Business Lists."

Some drywallers are also involved in remodeling and repair work, while others do drywall work in conjunction with other specialty work such as painting or acoustic ceiling installation. The local yellow pages listings under drywall contractors provide information on types of jobs done, types and number of entities, and material suppliers. Some advertised services are commercial and residential work, remodels, sheetrock repairs, texturing, round corners, metal stud framing, water damage repair, acoustical spray ceilings, suspended ceilings, plastering, and door hanging. The taxable entities include sole proprietors who report their income on Schedule C. Such entities often evolve into partnerships and corporations.

A general assessment of the business environment during the years under audit should be made, since the types of drywall jobs available and the profitability of these jobs will vary according to economic conditions. When new construction is booming, drywallers work non-stop and their tax returns show increases in labor and equipment expenses as additional work crews are used. When the local economy is prosperous there will be more remodeling jobs available. Conversely, during depressed times work becomes scarce and profit margins shrink. Bidding becomes even more competitive and drywallers are forced to submit lowball bids just to get jobs. Drywallers may even take jobs on a breakeven basis to maintain business relationships with general contractors. Drywallers may also shut down operations for a month or so during slow times.

Since all of the aspects of the business environment affect items reported on drywallers' tax returns, an analysis of the business environment is necessary to identify and develop issues pertaining to a particular audit. The assessment of the business environment should include a determination of the entity's functional structure. Drywallers often develop relationships with particular general contractors or other specialty contractors. These relationships, along with area practices such as prevalence of unions or use of a builder's exchange, affect the types of jobs and profitability. Other aspects of the business environment to consider include local building codes, local licensing requirements, and the types and ages of buildings in the area.

Chapter 2

INDUSTRY BACKGROUND

INDUSTRY PRACTICES

In addition to being aware of general construction industry practices and the business environment, an examiner should also be aware of specific industry practices that pertain to drywallers. A description of a basic drywall job will serve to make the specific practices evident. The first step of a drywall job is the bid. On new construction and municipal jobs a competitive bidding process is common. On smaller jobs the bidding process is less formal. Because drywall installation is one of the final phases of construction, the area to be covered with drywall can be accurately estimated. The materials component of the bid can then be accurately estimated since wallboard prices are stable. Standardized wallboard is usually used on jobs (1/2" thickness for residential, 5/8" for commercial). Labor costs are more variable. If drywall is to be installed on a multi-storied building, more labor is needed. If the wall area is of irregular dimensions, more labor will be needed to cut and install the wallboard. Labor costs also vary according to the type of finish used. For example, kitchens and bathrooms require a smoother texture to make these walls as water resistant as possible. Labor costs are also affected by the extent to which the rooms are finished with moldings or door frames.

When a bid is accepted, contracts are entered into and then the first step of a job is to have the wallboard "stocked" (delivered to the job site). The construction process usually results in the drywaller receiving 2 to 3 weeks notice before the job is ready for wallboard installation. During this period wallboard may be stocked by the drywaller or by the supplier. A 3/4 ton truck can hold 40 to 50 sheets of wallboard, which is sufficient to stock wallboard for remodeling jobs. Drywallers working larger jobs use larger trucks and forklifts. Five percent extra wallboard is usually stocked to account for waste. Since wallboard is relatively cheap, it is more cost effective to use more board than it is to piece together scrap. Scrap wallboard has no value. Some remodeling jobs may require demolition work before the drywall is ready to be installed.

Wallboard installation has two components: "hanging" and "taping." Hanging consists of attaching (often with metal screws every 7 inches on center) the wallboard to wall studs and ceilings. Hanging standard size wallboard of 4 feet by 8 feet requires strength more than it does specialized skills. On smaller remodeling jobs the general contractor may stock and hang the wallboard and then subcontract a drywaller to do the taping. Taping consists of sealing the wallboard seams with tape and then "texturing." Texturing consists of applying a finishing or skim coat to conceal the tape

and fasteners and then sanding to a smooth finish.

Tapers require specialized skills and tools. The type of finish applied can vary greatly. However, note that seams are almost always taped, since taped seams are a fire code requirement. Since taping is messy work, clean up of the job site is often a contracted requirement. Note that drywallers working commercial jobs may also contract to do "framing," which is the installation of wood or metal framing onto which drywall is hung.

INDUSTRY PARTICIPANTS AND CONSIDERATIONS

Sole proprietors, partnerships, and corporations do work as drywall contractors. These entities have as their common basis the skilled craftsmen who do the hanging and taping. Partnerships and corporations evolve as these craftsmen develop their businesses by hiring employees and bidding on larger jobs. Drywallers also develop relationships with other contractors which can lead to the formation of larger entities. In auditing drywallers, it is imperative to assess where the particular taxpayer lies on the continuum between sole proprietor and integrated corporation to determine whether the tax return has evolved to incorporate the more complex issues that larger entities face. Note that if you are auditing a large construction contractor for whom drywalling is only a minor segment of the business, or for information on general contractors, consult the MSSP Construction Industry Guide.

Their backgrounds as skilled craftsmen give drywallers inherent strengths and weaknesses in running a business. Their experience in doing the work themselves gives them an understanding of the labor component of jobs and allows them to organize a workforce to fulfill a contract at the agreed price or lower. For experienced drywallers, bidding small jobs is second nature. They can eyeball the work to be done, mentally compute the industry standard of 50 cents per square foot for hanging, taping, and texturing, include a premium for any extraordinary circumstances, and arrive at an accurate bid. Because materials must be pre-ordered for jobs, drywallers are very aware of cash flow. On larger jobs, normal billing terms are for 35 percent at time of stocking, 35 percent once hanging is completed, and 30 percent upon completion. Such terms force drywallers to match cash outflows with their inflows. In some states, cash inflows are restricted by laws which limit advance payments to the lesser of 10 percent of the contract price or \$1,000. In addition, since drywallers do not usually rely on outside financing, maintaining positive cash flow is imperative.

Their awareness of costs enables drywallers to make profits on jobs. However, profitability may not be reflected on the books and records. Such books and records often consist of just a check register and job files, even for drywallers with millions of dollars in gross receipts. A system based upon bank accounts will not show diversions

of assets or off-book transactions such as when expenses are paid from business receipts before the receipts are deposited. Expenses can be difficult to track when invoices are kept in job files and payments are made "on account" instead of on a per invoice basis. Drywallers tend to rely on their sense of profitability rather than upon books and records and, therefore, may stay with an inadequate accounting system. However, better records may be required as businesses grow. For instance, accrual basis financial statements may be required to secure bonding; or detailed accounting records may be needed to secure outside financing. If the business has grown but the accounting system has not, close scrutiny is required. During audits a determination must be made as to whether the accounting system is adequate.

Another area of consideration is internal controls. Small operations will not have any internal controls and this may carry over to larger entities. Procedures for billing, handling of receipts, and expense authorizations should be scrutinized, especially for corporations, to see if improper tax accounting has occurred. On the other hand, other drywallers may institute certified audits or reviews as their businesses grow. The examiner must determine whether the internal controls are adequate.

Another important consideration is the workers who do the actual drywall installation and other contracted requirements of jobs. An understanding of these workers' roles gives insight into income and employment tax audit issues. Drywallers use different combinations of workers to complete drywall jobs. The types of workers used vary based upon the size of the operation, the types of jobs worked, and the types of skills held by the drywaller. Drywall workers are generally trained in all aspects of drywall installation; which can include framing, hanging, taping, floating, and sanding. The drywaller may directly supervise these workers or have a foreman who assigns tasks to the workers according to their skills and the requirements of the job.

Costs again influence drywallers when determining the types of workers to use on jobs. Many drywallers maintain only a limited number of permanent employees. Within the local area there are pools of workers that are used by drywallers as needed on a job by job basis. This way a drywaller can take on more work in times of high demand without exposing himself or herself to high overhead during slower times. Drywallers also minimize costs by hiring workers with the lowest skills necessary to complete the job. For example, a small contractor may hire unskilled workers to do the hanging and clean up and do the taping work himself. The employer's desire to minimize costs is not a justification, however, for categorizing workers as independent contractors when application of the common law indicates that they are employees.

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Chapter 3

INDUSTRY ISSUES AND AUDIT TECHNIQUES

PREPLAN AND ISSUE IDENTIFICATION

The following issues have been identified as areas of noncompliance and should be considered when auditing drywallers. A familiarity with these issues will assist you in assessing the audit potential of a drywaller.

1. **Change in Accounting Method** — This issue should be considered for all drywallers using the cash method of accounting. This issue is thoroughly discussed in the MSSP Construction Guide as well as in the MSSP Job Aid entitled "Cash vs. Accrual Method and the Construction Industry."
2. **Employee versus Independent Contractor** — If the tax return shows little or no wages, large subcontractors expenses or no deduction for workman's compensation insurance, employees may be incorrectly classified as independent contractors.
3. **Inadequacy of Records** — Noncompliance with record keeping requirements may mean that the taxpayer is subject to back-up withholding assessments.
4. **Bad Debts** — This is an area of noncompliance for both cash basis taxpayers and non-cash basis taxpayers with excessive bad debt deductions. Bad debts require an inquiry into the following:
 - a. whose debt is it?
 - b. is it business or non-business?
 - c. have the funds actually been transferred or were there only adjusting journal entries?
 - d. has interest been charged and reported? and
 - e. are there documents to support the transactions?
5. **Unreported Income** — This issue should be considered whenever the financial status shown on the tax return is questionable. The MSSP Construction Industry Guide addresses this issue.

6. **Skimming** — Sampling techniques should be used to verify income. Skimming is most prevalent in prospering businesses and this issue is most likely to be present when the tax return shows lower profit margins during times that the construction industry is booming. If such discrepancies are found, a more in-depth reconstruction of income may be warranted.
7. **Other Deductions** — Items listed as "other deductions" on the tax return should be scrutinized. Any questionable items should be examined.
8. **Related Party Transactions** — Related party transactions are thoroughly discussed in the MSSP Construction Industry Guide under "Construction Industry Issues and Audit Techniques -- Related Party Transactions."

PRE-AUDIT -- IN GENERAL

The pre-audit analysis should be used to identify issues and determine the scope of the examination. For drywallers, the issues and scope are affected by the taxpayer's sophistication, business structure, and financial status. CFOL information should be used to compare the tax return under audit with prior and subsequent years. The comparative analysis should also be used to identify large, unusual, and questionable items to address during the audit. Trends of the business under audit should be identified and compared to trends of the construction industry as a whole. If the preliminary Cash-T of a Schedule C raises questions regarding the reasonableness of the taxpayer's financial status, then the depth of the analysis should be increased and the issue addressed with the taxpayer during the examination. See the MSSP Construction Audit Techniques Guide for additional information.

The pre-audit should also include consideration of the drywaller's business structure. The business structure is important since it affects how income is derived and reported. If related entities are shown on the tax return, CFOL research should be done so that consideration can be made of the business as a whole. The related entities and their controlling parties should be flow charted. Note that there must be at least two entities audited to test for related transactions. The most likely scenario for related entities for drywallers is when related partnerships are set up either for financing purposes or for a related function such as for a drywaller/painter operation. When there are no related taxable entities, it is still important to analyze the business structure during the pre-audit. The return can contain information regarding relationships with subcontractors or unions which will have a bearing on how income is derived.

An analysis of the depreciation schedule can also help determine structure. For instance, the number of trucks listed gives an indication of the number of work crews

used. If painting equipment or an acoustic ceiling spray machine is listed, the taxpayer should report work in addition to drywalling. Large deductions for subcontractors can also indicate that work other than drywalling is being done and may also indicate an employee vs. independent contractor issue.

The depreciation schedule can also indicate potential issues. For example, a detailed depreciation schedule listing the individual assets could indicate improper recovery periods claimed. The depreciation schedule may also show fully depreciated equipment that has actually been disposed of at a gain. When new vehicles are shown as being placed in service during the audit year, the taxpayer should be questioned as to whether an old vehicle was traded in, sold, or converted to personal use. If the taxpayer states that the new vehicle is an addition to the fleet, the return should reflect related increases in labor expenses and income to reflect the increased capacity to perform jobs.

PRE-AUDIT -- CORPORATIONS

An important component of the corporate pre-audit is the balance sheet analysis. **Related party transactions** may exist if there are balances in the shareholder loan account or the balance sheet includes "other assets" or "other liabilities." Increases in assets should also be scrutinized since taxpayers may receive property as payment for work performed. As drywaller entities grow they become more capital intensive. When the owners infuse cash into the business to meet the increased capital requirements, these infusions should be included in the financial status analysis of the owners. Indications of draw accounts or payments of personal expenses by the corporation may indicate dividend issues.

If the "other assets" and "other liabilities" sections include the accounts "Costs in excess of billings" and "Billings in excess of costs," the taxpayer uses the percentage of completion accounting method. The MSSP Construction Industry Guide should be consulted, as it includes information on M-1 analysis and an explanation of IRC section 460 issues.

During the corporate pre-audit the "**other deductions**" should be analyzed. Any inconsistencies with other tax years or to other items on the return should be addressed during the audit. As with any other examination, excessive repair expenses claimed may indicate the improper treatment of capital improvements.

PRE-AUDIT -- CONCLUSION

Upon completion of the pre-audit, the examiner should be able to formulate preliminary assessments of:

1. the taxpayer's sophistication;
2. the structure of the taxpayer's business; and
3. the financial status of the taxpayer.

These assessments should be used to determine the audit potential of the pre-identified issues listed at the beginning of this section, as well as any issues identified during the pre-audit. When the initial contact letter is sent out, the initial Information Document Request should be customized according to the pre-audit information. The use of the pre-audit to determine the scope of the audit will maximize the efficiency of the initial interview.

INITIAL INTERVIEW

The initial interview should be used to gain an understanding of the business and its books. It is important that the interview be held with someone who has first-hand knowledge of the business so that any unique practices can be adequately explained. Drywallers often establish their own niches based upon relationships with other contractors. It is important to gain an understanding of these relationships and how they affect the income and expenses of the business. On a small remodeling job, a general contractor may do the framing and hanging and then hire a drywaller to do the taping. If the job is small enough, the licensed drywaller may tape the job himself or herself. On larger jobs, the drywaller may use unlicensed workers.

The structure of the business develops as it enlarges, and the duties of bidding, estimating, and job supervision may be delegated to others. The drywaller may use work crews which include licensed drywallers who may either supervise jobs or do the installation themselves. Varied relationships may exist during the year as work crews expand or contract according to the amount and types of work available. Therefore it is important to determine the range of work done, which can vary from framing through painting or include demolition and clean up. During the initial interview these relationships need to be understood to determine whether the employment tax treatment is correct.

A tour of the business can provide information regarding specific business practices such as whether the drywaller has a stock of wallboard that is being sold wholesale. A tour of the business is also helpful because observations of the business office and construction equipment on the premises can help the examiner to conceptualize how jobs are performed. It is also beneficial to conduct the audit at the taxpayer's place of business, as day-to-day observation of the business can lead to a more thorough understanding of the structure of the business operation, including how source

documents are generated and accounted for. From these observations the examiner can also judge internal controls and the separation of duties and then customize the audit plan. It will then be easier for the examiner to determine whether the books and records adequately reflect the business activity.

Included in this guide are sample initial interview questions. This list of questions is not all inclusive. These questions should be customized to include issues identified during the pre-audit and to omit items that do not pertain to the taxpayer. After conducting the initial interview, the examiner should have an understanding of how the business operates and how responsibilities are divided among the employees.

During the interview the examiner should go over the items requested on the initial IDR. If any material items are missing and the taxpayer is unable or unwilling to provide the information, contacts with third party sources of information should be considered. Sample IDRs have not been included in this guide due to the differences in the types of entities that install drywall, and due to the fact that you want the initial IDR to be general in scope. While you will not examine every record that exists and is available for the audit, having access to these records will allow you to customize the examination of the records as efficiently as possible once you narrow the scope from information gained from the pre-audit and initial interview.

The interview should give the examiner a sufficient understanding of the books to identify missing items and make a preliminary assessment of internal controls. The comparative analysis, Cash-T, and related parties flow chart should be updated after the initial interview. Issues identified during the pre-audit should be evaluated and sampling techniques should be developed to verify issues.

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 from the IRS Home Page on the Internet (<http://www.irs.ustreas.gov>).

The first step in any case involving worker classification is to consider section 530. Before or at the beginning of any audit inquiry relating to employment status, an agent must provide the taxpayer with a written notice of the provisions of section 530. If the requirements of section 530 are met, a business may be entitled to relief from federal employment tax obligations. Section 530 terminates the 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. Internal Revenue Code section 3121 (d) (2). *Nationwide Mutual Insurance Co. V. Darden*, 503 U.S. 318 (1992).

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

The regulations provide that, generally, the employer's right to control the manner in which the work is performed is the most important factor in analyzing employment status for tax purposes. The examiner will need to 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.

REQUIRED FILING CHECKS

As in any examination, the required filing checks must be considered. Inspect all retained copies of employment returns, including Forms W-4. Additionally, inspect all Forms 1099 and determine whether Forms W-9 were secured. It is important to determine whether all federal tax and information returns have been filed, as this is a requirement to qualify for **Section 530** relief regarding the classification of workers as employees or independent contractors. Another required filing check is the inspection of related entity returns. This includes the tax returns for owners, as well as any brother/sister companies.

RECONCILIATION OF BOOKS TO RETURN

The books should be reconciled to the tax return before specific issues are addressed. For Schedule C audits this reconciliation usually involves matching yearend totals from the cash disbursements and cash receipts journals to amounts shown on the tax return or the reconciliation may involve a trial balance or specific book to tax workpapers. If the taxpayer uses accounting manuals, they can be examined to provide insight into the accounting system. Specific tax workpapers and/or any public accountant's reports on

the business should be requested early to help in reconciling the books. The reconciliation enables you to become familiar with the books and records and gives an indication of their complexity, accuracy, reliability, and completeness.

Inadequate records are common for drywallers. Inadequate records can result when the business expands but the bookkeeping system doesn't. Larger jobs may involve progress billings and the hiring of employees or subcontractors, which necessitates greater complexity of the books. In addition, when materials invoices and other receipts are maintained in job files, it can be difficult to verify line items of the tax return.

During the reconciliation of the books to the return, the examiner should determine whether the bookkeeping system properly accounts for differences between book and tax income. For Schedule C audits the difference between book and tax can involve a conversion between the accrual and cash methods of accounting. It is also common for small contractors to change their computerized bookkeeping systems during the year, as software often only has a useful life of 2 to 3 years. If a new system is implemented during the tax year, changes in the system and adjusting entries to convert the systems should be scrutinized. For corporations differences between book and tax income should be reported on Schedule M-1.

The reconciliation of the books to the return gives the examiner an overview of the taxpayer's books and records. This overview allows the examiner to identify discrepancies and consistencies between the books, initial interview, and pre-audit analysis. Issues needing further development should be identified and the audit plan should be revised and narrowed accordingly. At this point the examiner should also determine whether the books can be relied upon as verification of the tax return. If the books cannot be relied upon, third party contacts should be considered.

EXAMINING SOURCE DOCUMENTS

Job Files

Drywallers often organize source documents in job files. Job files may contain the following items:

1. a copy of the contract with the owner
2. a copy of the formal bid or informal bid estimates
3. invoices for materials and other costs
4. invoices for progress billings
5. correspondence with the owner, subs, and city/county officials
6. contracts with subcontractors

7. bills received from the subs
8. change orders with subs and/or owner
9. bonding information
10. lien releases from subs

The depth of the examination of job file information will vary depending upon the state of the formal books. If the taxpayer has audited financial statements that reconcile to the tax return, sampling of information in the job files may adequately verify income and expense items. If the formal books cannot be relied upon, job file information can be used to reconstruct income and expenses. Job file information should always at least be sampled since sampling enables the examiner to see how jobs are actually performed from the bid to completion. The examiner can then better assess how accurately the books reflect the business activity. The following descriptions explain how specific job file information can be used in audits.

Contracts With Owner/General Contractor

Income can be verified by matching the contract price and billing terms to Accounts Receivable entries. Contracts also contain descriptions of the specific work to be performed. These descriptions should be compared to billing invoices and to the books to verify that all **income** has been reported. Contracts with add-ons or special terms should be scrutinized to verify that income has been properly reported. For instance the contract may provide for bonuses or penalties for early or late completion, in which case the contracted time frame should be compared to the actual time incurred.

Contracts can be helpful when working a **bad debt** issue, as they specify the form and method of payment. For example, if the drywaller receives payment through the general contractor the "bad debt" could actually be a performance dispute with the general contractor regarding amounts that have already been released by the owner. Contracts may also specify alternate forms of payment such as an interest in the property. Such noncash compensation may not have been considered in computing the bad debt deduction.

The business nature of expenses can be verified by comparing invoices in the job file to the contract's description of work to be performed. Contracts also contain information regarding who has title to uninstalled materials stored at job sites. Whenever the sale of merchandise (such as drywall materials) is an income-producing factor, inventories are required and the accrual method must be used (at least for the purchase and sale of merchandise, if not overall). See Treas. Reg. section 1.446-1(a)(4)(i) and (c)(2)(i). If the contract provides that the drywaller holds title to uninstalled materials stored at job sites, this material, at yearend, serves to increase the drywaller's ending inventory.

This reduces the drywaller's "cost of materials sold" under the periodic inventory method generally employed by drywallers. For drywallers using the completed contract method of accounting, contracts for jobs more than 90 percent complete should be examined to determine if all of the contract terms have actually been met.

The following areas should be considered when the taxpayer has time and material contracts:

1. Inflating time and material work tickets (Daily Labor and Equipment Reports) with nonexistent numbers of employees;
2. Employees who worked on unit price and lump sum contracts were charged to time and material contracts;
3. Inflating billings with equipment that was idle and/or down for repairs;
4. Equipment operated on lump sum and unit price contracts was charged on time and material contracts.

Bids and Estimates

Bids provide information on how the drywaller determines its profit margin. On bids where the drywaller estimates its costs for labor and materials and then adds a profit margin, materials represent an income-producing factor. Therefore, inventories and the accrual method of accounting are required. Drywallers are usually able to accurately estimate labor and materials costs for jobs. Therefore bid estimates should be compared to actual labor and material expenses, and discrepancies should be addressed.

Materials and Other Expense Invoices

Materials invoices should match bid estimates in quantity and price. Materials invoices may also show the address to which the materials were delivered. This address should match the job location. If a test check indicates that materials were delivered to the site or subdivision where the taxpayer's residence is located, the examiner should check to see whether the materials and related labor costs relate to the taxpayer's personal residence. Delivery dates outside of the business' normal days of operation can also indicate **personal expenditures**.

Progress Billing Invoices

These invoices should match the payment terms and amounts stated in the contract. For cash method taxpayers that do not record progress billings in an accounts

receivable ledger, the accounts receivable balances may need to be constructed as part of the determination as to whether "substantial identity of results" exists between the **cash and accrual methods of accounting**. In such cases the progress billings in the job files should be matched to the cash receipts journal, with the outstanding billings constituting the accounts receivable balance.

Correspondence

Correspondence in job files may indicate informal change orders or complications on a job. The examiner should ensure that these activities are properly recorded on the books.

Contracts With Subcontractors

If the job file includes contracts with subcontractors, the examiner needs to verify that **Form 1099 requirements** have been met. Payments to the contracted party should be scrutinized as they may have been misclassified to avoid the Form 1099 requirements. These contracts should also be examined to see if the subcontractor has contracted to provide materials. If so, the drywaller may be double-deducting materials expenses. Such double deductions are most likely when the taxpayer uses cost-plus contracts. When contracts with subcontractors exist, the **employee versus independent contractor** issue should be addressed. As with materials invoices, the job site addresses shown on these contracts should be screened for possible **personal expenditures**.

Billings From Subcontractors

Billings from subcontractors should be matched to the contracts with subcontractors and any discrepancies should be addressed. These billings may constitute amounts subject to payroll taxes. The billings can be used to trace amounts that may be buried in the books.

THIRD PARTY CONTACTS

Third party contacts may be warranted only when the taxpayer is unable or unwilling to provide information requested or to verify information provided by the taxpayer or when the following situations are encountered. RRA 98 Section 3417 (Notice of Contact of Third Parties) procedures **must** be followed.

Bad Debts

Legal action taken to attempt to collect on unpaid debts can serve as proof of worthlessness of bad debts. Court records can be researched to find out the amount of the debt as well as the amount recovered. Note that even if court records show that a bad debt was sustained, if the bad debt resulted from an uncollected fee, it is only deductible if the bad debt was previously included in income.

Unreported Income

Third party contacts may be warranted in cases where the taxpayer's financial status is in question, when records are missing or incomplete, or when discrepancies arise in the examination of materials, labor, or other expenses. If the preliminary analysis indicates a significant imbalance in cash flows, the taxpayer (or representative) should be notified that there is an issue and given the opportunity to explain or resolve the material imbalance.

When smaller drywallers do not have bonding or similar requirements which require financial statements and performance verification, income may be reported for only a portion of their work. Some drywallers are willing to work for 20-25 percent less on the condition that no Form 1099 be issued. This has an adverse affect on the industry as well as the IRS. With the proliferation of check cashing schemes, payment with a check is an insufficient control to validate income via bank deposit records.

If the drywaller has incomplete records, the examiner may be able to obtain information regarding the amount of sheetrock purchased during the year from building supply houses. By analyzing bid estimates, a figure for dollars of income per dollar of sheetrock can be determined. Business receipts can then be grossed up according to total sheetrock purchases. When the taxpayer has incomplete records regarding labor costs, one third-party source is workman's compensation insurers. These insurers often "audit" their insureds to verify whether the insurance coverage matches the actual employment costs. These costs can be grossed up to determine a figure for gross receipts.

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GLOSSARY

- B -

Back Charges — Billings by a general contractor to a subcontractor to cover expenses for which the subcontractor is responsible per the contract terms.

Bonds — Bonds are a form of third party guarantees used to ensure payment or performance on contracts. They typically cost 25 percent to 75 percent of the gross contract. If the contractor defaults, the bonding company is responsible for meeting the contractual obligations. Municipal and other government contracts usually require surety bonds (bonds issued by surety companies). However, many businesses, especially smaller ones, cannot meet the financial requirements of surety companies. In these cases, collateral bonds may be issued in the form of realty or personalty bonds in which the contractor pledges real or personal property as collateral in value equivalent to the contract price. Also note that contractors are often required to be bonded to meet state licensing requirements. Bonds are used for the following purposes:

1. **Bid Bonds** — Used to ensure that the successful bidder will sign a contract for the bid price. Default results in payment by the surety of the difference between the accepted bid and the next lowest bid.
2. **Performance Bonds** — Used to ensure that the project is completed according to the terms of the contract.
3. **Payment Bonds** — Used to ensure that all vendors and subcontractors are paid.

Bonus Clause — A premium paid to the contractor in excess of the basic contract price as a reward for meeting various goals stated in the contract; for example, completing the project prior to the contract completion date. The provisions for bonuses are stipulated in the bonus clause of the contract and are in contrast to the penalty clause.

Builder's Exchange — An organization that goes out and finds pending construction projects and posts them so that competitive bids can be made on the jobs. Note that when the general contractor submits a bid, he or she is required to list all subcontractors to be used on the job. Therefore, the exchange is a potential source of information regarding related contractors.

Building Permit — Permission granted by the local government to construct a building or to make property improvements.

Change Orders — Change Orders can be initiated by the contractor or the owner. A change order modifies the original contract. Change orders initiated by the owner most commonly represent additions to the contract for additional work or features. Change orders initiated by the contractor usually cover cost overruns under extenuating circumstances such as increased costs due to market conditions. It is important to analyze the change orders and include the additional costs in the cost of goods sold and/or percentage of completion calculation.

Since drywall application occurs as a later phase of construction, change orders are not as prevalent for drywallers as they are for other construction contractors.

Construction Managers — Also known as project managers, they are employees of the General Contractor. A manager is delegated such authority as supervising the job site or scheduling sub-contractors.

Contractors — Contractors perform the construction work in accordance with the plans and specifications provided by the owner. Contractors are generally required to be licensed by the State under separate classifications (plumbing, drywall, general building, etc.).

Contracts — Contracts are written agreements which specify the work to be performed, the amount and timing of payments, and the division of responsibility between the contractor and the customer. General contract provisions include the agreement, general conditions, supplementary conditions, technical specifications, and addenda. The provision stating which party holds title to uninstalled materials held at the job site is an important consideration in determining whether these materials must be included in the drywaller's ending inventory at year-end. Assuming that the sale of materials is an income-producing factor, inventories, and the accrual method of accounting are required under Treas. Reg. section 1.446-1(a)(4)(i) and (c)(2)(i). However, if title to uninstalled materials will not be included in the drywaller's ending inventory at yearend (even though the use of inventories may be required). See *J.P. Sheahan Associates v. Commissioner*, T.C. Memo. 1992-239. The most common types of contracts are:

1. Fixed Price Contracts — One set price is charged for the entire amount of work to be performed. These contracts are common on small jobs with standard specifications and an experienced contractor can price them off the top of his head.
2. Time and Materials Contracts — Payment is based upon direct labor hours at a fixed rate plus the cost of materials and other specified costs. The profit margin is built into the labor cost so these contracts are likely to be used on labor intensive jobs.

3. Cost-Plus Contracts — Labor and materials costs are determined, then a profit margin is added to arrive at the gross contract price. Most Cost-Plus contracts have a guaranteed maximum to protect the owner from cost overruns. Many Cost-Plus contracts allow the contractor to share in cost savings if the project comes in under budgeted cost.
4. Long Term Contracts — These are defined in IRC section 460(f)(1) as any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into. Issues relating to these types of contracts are discussed in the MSSP Construction Industry Guide.

Commerce Building Daily — A trade publication that lists construction jobs that are open to competitive bids.

- D -

Drywall Construction — May include the application of lumber, plywood, and hardboard paneling to interior walls and ceilings. However, it generally involves the application of gypsum board (which is powdered gypsum rock encased in heavy paper). **Gypsum board** is also referred to as **drywall**, **sheetrock**, or **wallboard**. When used as a base for plaster, it is referred to as **plasterboard** or **rock lath**. Standard drywall is 4 feet wide by 8 feet long with 10, 12, 14, and 16 foot lengths available. The standard thicknesses are 1/2 inch for residential construction and 5/8 inch for commercial work. One-fourth inch thickness is used when plaster walls are covered, or for curved surfaces, where multilayers are used.

- F -

Framers — Framers install the wall or ceiling substructure which consists of wood or metal tracking and stud work.

- G -

General Contractors — One who contracts for the entire construction of a building or project, rather than a portion of the work. A general contractor typically hires subcontractors, such as plumbers or drywallers, coordinates all work, and is usually responsible for payment to the subcontractors.

- H -

Hangers — Workers who attach drywall to wood or metal framing. Note that hanging drywall requires strength more than technical skills, therefore, a general contractor may choose to use unlicensed laborers as opposed to licensed drywallers for this work. Building codes specify the minimum amount of nails required to attach drywall. A typical requirement is for nails to be spaced a minimum of 8 inches on center on walls and 7

inches on center on ceilings.

- M -

Material Suppliers — Material suppliers provide the raw materials used by drywallers.

Materials are purchased and installed by the drywaller in accordance with the contract with the general contractor. General contractors often write joint checks to drywallers and material suppliers to ensure that all parties have been properly paid. Materials are generally delivered directly to the job site.

Mechanic's Lien — A lien on real property in favor of persons supplying labor or materials for a building or structure, generally for the value of the labor or materials provided. A mechanic's lien also exists for professional services in some states. Clear title to the property cannot be obtained until the claim is settled. Regulations regarding mechanics liens are found in the state civil codes. Generally, to be enforceable, preliminary notice must be given and then the lien must be recorded within a specified time period either after completion of the job or after the notice of completion is issued. The lien recorder then has a specified time period in which to commence an action to foreclose the lien or it will be voided. Lien information can be found at the county recorder's office.

- N -

Notice of Completion — On construction projects, a Notice of Completion is issued by the municipality once the building is completed and the project passes final inspection. Construction contracts often use the Notice of Completion date as the date of final payment when progress billings are used. Notices of Completion are recorded at the Hall of Records, along with the Certification of Occupancy of Records. At this point the property is appraised for property tax purposes. These appraisals can provide information for developing timing or allocation issues.

- P -

Penalty Clause — In contrast to the bonus clause, this provision of the contract provides for a reduction of the amount payable under a contract if the contractor fails to meet specified targets or project specifications.

Preliminary Notice — If a subcontractor has completed a job and has not received payment within a couple of weeks, he has 60 days to file a preliminary notice to gain the right to file a lien.

Progress Payments — Under this method, payments are made on jobs according to the stage of completion. A drywaller's contract may have billing terms of 35 percent of the contract price upon stocking, 30 percent after the sheet rock is hung, and 30 percent upon completion, with a 5 percent retention released 30 days after the Notice of

Completion date.

Punch List — A list prepared by the architect or owner near the completion of a project indicating items to be completed or corrected by the contractor.

- R -

Retainages — Retainages are amounts held out of a contract to ensure satisfactory completion. A common practice is to hold 5 percent of the gross contract price as a retainer, which is released once the job is completed and accepted or within 30 days from the issuance of the Notice of Completion.

Rider — An amendment to a contract.

- S -

Sublist — A sublist shows all subcontractors who are to work on a job that the general contractor is bidding on. The sublist is included with the general contractor's bid.

Subcontractors — The largest number of taxpayers in the Construction Industry, including most drywallers, are Specialty or Subcontractors. They can range from one-man operations to nationwide, publicly traded corporations or divisions of larger corporations. Specialty Contractors are distinguished from the General Contractor by the limited scope of their work, which usually involves a special skill, knowledge, or ability.

As subcontractors, drywallers generally enter into contracts with the general contractor (GC). Under such contracts, the drywallers generally supply the materials used on jobs. The GC, not the owner of the property, will usually pay the subcontractors. Materials purchased by the subcontractors are generally delivered directly to the job site. The subcontractors' work may be completed in stages or it may be continuous. The GC and the subcontractors may be related or may have formed "families" between the GC and several frequently used subcontractors. Working closely together on numerous jobs can lead to collusion.

Surety Companies — Surety companies (often insurance companies) provide bonding to construction companies. Contractors must submit detailed financial data to the surety company to secure a bond. Therefore surety companies are good sources of third party information if third party contacts are warranted. Financial statements prepared in accordance with generally accepted accounting principles (GAAP) are often furnished to the surety on a quarterly basis or more often. Supporting schedules included in these financial statements provide extensive job information required by the surety company to analyze and limit their risk. Personal financial statements are often required to be supplied from officer/shareholders.

- T -

Tapers — Once drywall is installed, tapers conceal the screws or fasteners, reinforce and conceal drywall joints, and finish the surface. Tape is applied to the joints, which are then covered with joint compound (mud). This "mud" is then applied to the remaining drywall surface to achieve the finished texture. The smoothness of this texture (and required amount of labor) will vary according to whether the wall is to be painted or wallpapered. Also, kitchens and bathrooms tend to require the smoothest finishes to ensure that these walls shed as much water as possible.

Title — Title can be defined as the coincidence of all the elements that constitute the fullest legal right to control and dispose of property. Contracts usually specify whether the drywaller holds title to uninstalled materials stored at job sites. If drywall materials are determined to be income-producing factors, inventories and the accrual method of accounting are required. If the drywaller holds title to uninstalled materials held at job sites, these materials should be included in the determination of ending inventory and cost of goods sold, as explained above.

- U -

Union/Non-Union Subcontractors — The presence of unions in the industry adds another dimension to the construction environment. In some cases a taxpayer may set up separate companies, one union and one non-union. The companies may or may not share employees, ownership, supervision, equipment and offices.

Appendix A

SAMPLE

INITIAL INTERVIEW QUESTIONNAIRE

TAXPAYER:

DATE:

FORM/YEAR:

EXAMINER:

INTERVIEW CONDUCTED WITH:

POWER OF ATTORNEY:

COMPANY CONTACT:

ADDRESS:

TELEPHONE NUMBER:

BACKGROUND:

1. Any prior audits? (including state, federal, union, workman's comp.), outcome of audits?
2. Any amended returns, filed or planned?
3. All required returns currently filed? (corp., pension, W-2, W-4, 1099)
4. Are there any changes that you are aware of that should be made to the return under audit?
5. Describe how the business originated, and how it evolved to its current operation.
 - a. Any changes in entity (e.g. sole proprietorship to partnership to corp., etc.), and when did they occur?
 - b. Any related entities--corps, partnerships, joint ventures, etc?

TAXPAYER:

DATE:

FORM/YEAR:

EXAMINER:

- c. Are any officers, directors, or shareholders involved in any other construction entities?
 - d. Any joint ventures?
 - e. Any major changes in ownership or new issuances of stock?
6. Describe the principal business activity for the year under audit. (Type of contracting, small or large jobs)
- a. Are all jobs done as a subcontractor?
 - b. Are contracts entered into for all jobs?
 - c. Are jobs commercial or residential?
 - d. If residential, do jobs involve new construction, remodeling, or both?
 - e. Do residential jobs involve tract developments or individual units?
 - f. How large are jobs (what is dollar range of contracts)?
 - g. Who are your customers (any state or federal contracts)?
 - h. How do you get jobs?
 - i. In what geographical range are your jobs located?
 - j. What type of contractor's licenses are held, by whom, and when were they obtained?
 - k. Is your business subject to any regulatory authority?
7. Describe the bidding process and how a contract is entered into.
- a. Who provides bids and prices?
 - b. How are job costs and profit determined for bids?

TAXPAYER:

DATE:

FORM/YEAR:

EXAMINER:

- c. Are bids competitive or negotiated? or both?
 - d. Are engineering specifications (blueprints, plans, architecture) supplied for bids or do you have to provide them?
 - e. Who negotiates contracts?
 - f. What type of contracts are used? (for example, cost plus, time, and materials)
 - g. If materials costs are part of contracts, are actual or retail costs used?
 - h. Are standardized contracts used?
 - i. Do you ever include incentive clauses for early completion or penalties for lateness in your contracts?
8. Describe or illustrate the sequence of work steps performed from start to finish of major contracts or projects, including approximate time frames.
9. How are material suppliers selected?
- a. Are contracts entered into?
 - b. Who are your main materials suppliers?
10. Who is responsible for materials management and coordination? (ordering and delivery of parts and materials)
- a. What are the time frames for ordering, delivery, and payment regarding drywall materials?
 - b. Is all drywall delivered to the job sites, or is an inventory of drywall kept on hand?
 - c. What payment terms do you have with suppliers?
 - d. Are you involved in retail sales of drywall or other job materials?

TAXPAYER:

DATE:

FORM/YEAR:

EXAMINER:

11. Are you required to obtain permits for jobs?
12. How many projects do you have going at one time?
13. How are your projects financed?
 - a. Do you have a line of credit?
 - b. What loans do you have outstanding?
 - c. Are any loans personally guaranteed by the corp. officers?
 - d. Were you required to submit financial statements or other information to your lenders?
14. What are your insurance and bonding requirements?
 - a. What surety company do you secure bonds from?
 - b. Were you required to submit financial statements or other information (such as job lists) to the insurance or bonding companies?
 - c. Is such information available for this audit?
15. What are your days and hours of operation?
 - a. Is the business in operation for all 52 weeks of the year?
 - b. Is there a busy season, a slow season?
16. How many employees and types of employees? (that is, ratio of clerical to professional, size of labor force)
 - a. Describe the make up of the work crew that would perform a typical job.
 - b. Are any workers union members?

TAXPAYER:

DATE:

FORM/YEAR:

EXAMINER:

- c. Are any of the employees relatives of the sole proprietor or corporate officers? If so, give duties, titles, time spent on job, compensation.
 - d. What work is done by the corporate offices and how much time do they spend on corporate work?
 - e. How is officer/shareholder compensation determined? (salary plus bonus, other fringe benefits)
 - f. Does the number of employees vary on a seasonal or yearly basis?
17. Do you share your office space with any other businesses?
- a. If so, how do you allocate the space and arrange for rent payments?
 - b. Who is your landlord? (related either personally or through business?)
18. What type of equipment do you own? lease?
19. What other types of assets do you use in your business? own or lease?
20. Have you sold or disposed of any business assets in audit year?
21. Does corp. own or lease private passenger vehicles (boats or planes)? If so, is use assigned to specific officers, shareholders, or employees? What is the corp. policy regarding personal use?
22. What is your gross profit margin?
23. Do you have plans for your retained earnings?
24. Have there been any unusual or extraordinary events during the last 3 years? (that is, reorgs., acquisitions, dispositions, decline in income due to casualty, loss of prime supplies or customers, or other economic or business conditions)
25. Any major expansion or remodeling of plant or equipment in recent years?
26. Are there any plans to expand or diversify the business in the future?

TAXPAYER:

DATE:

FORM/YEAR:

EXAMINER:

27. What types of pension, profit sharing, or employee benefit plans does the business maintain?
28. What types of insurance policies are maintained? (health, life, disability?)

ACCOUNTING:

1. What method is used and when elected?
 - a. Have any Forms 3115 been filed?
 - b. Do you have any long-term contracts that exceed one taxable year?
2. Please describe in general terms the bookkeeping system that is used?
3. Do you use accounting manuals to determine accounting procedures?
4. Who kept the books and records for the year under audit?
 - a. How long have they been doing so?
 - b. Who currently keeps the books?
5. Where are the books and records kept?
6. What records are used to prepare your tax returns?
7. How long has the preparer of the _____ return been preparing your tax returns?
8. Was a certified audit or review done, and by whom?
9. Who does the adjusting and closing entries?
10. Does the basis of assets per books vary from the tax basis?
11. Do you keep an Accounts Receivable ledger?

TAXPAYER:

DATE:

FORM/YEAR:

EXAMINER:

12. Do you keep an Accounts Payable ledger?
13. What internal controls are used to safeguard the system?
 - a. Who signs checks, does payroll, etc.?
 - b. Who opens the mail?
14. If computerized, who has access to the records?
15. How are construction contract record files maintained? (for example, stored by contract in individual files)
16. What types of documents are kept in each contract file? (for example, bid bonds, performance bonds, contract, etc.)
17. What internal reports do you maintain? For example:
 - a. Job listing report? (list of active projects)
 - b. Revenue, cost, and gross profit report? (list of items for each project)
 - c. Project control statement/project analysis? (lists basic information about the project)
 - d. Change order status report? (lists for each project the status of all change orders)
 - e. What items are kept in the job files? (examine one)
18. How do you account for bid bonds and/or performance bonds?
19. How do you handle retentions in your accounting system? (Can be held out by general contractor or by themselves to a subcontractor, or held out by a municipality, etc.)
20. Do you perform services other than construction? (for example, engineering, architecture, contract management, or supervisory services)

TAXPAYER:

DATE:

FORM/YEAR:

EXAMINER:

- a. How are income and expenses from these services accounted for? Year earned or charged to related contract?
- b. Are these services separated in the contract? If not, how are they accounted for? (They should be "carved out.")

RECEIPTS:

1. What are your typical billing procedures?
2. How are receipts handled and by whom?
3. How many bank accounts (including savings) are used and which banks are involved?
4. Are there any foreign accounts?
5. How often are receipts deposited, and who deposits the receipts?
6. Into what account(s) are the receipts deposited?
7. Are receipts in the form of checks always deposited intact?
8. What other types of deposits are made into the bank accounts?
 - Who reconciles the bank statements?
9. Are there any cash transactions? (if so, go through 8300 checksheet)
10. What is your beginning and ending cash on hand? (only relevant to sole proprietorships or small corps.)
11. Do you keep a safety deposit box? (where, what are the contents)
12. Do you have any investments? (stocks, CDs, etc.)
13. How and when are sales recorded? (walk through a sample transaction)

TAXPAYER:

DATE:

FORM/YEAR:

EXAMINER:

14. What types of records are kept, that is, how are costs tracked for each job?
15. Were there any "add on agreements" extending the term of the contract or reporting of income? (for example, warranties or service agreements which are normally added after contract completion)
16. Do you perform work as a subcontractor? If so, when is income from jobs reported? (Delayed until general contractor done?)
17. When do you consider a job closed? How do you account for repair or other work you perform after job has closed?
18. Regarding mechanics liens, did you file any or receive any settlements from them in the year of audit?

INVENTORY AND COSTING:

1. Do you maintain inventories?
 - a. If so, what method do you use to cost inventory?
 - b. What items are included in inventory?
 - c. How do you account for overhead and other IRC section 263A costs?
2. Was any leftover/scrap material ever sold or used for other jobs?
 - a. How would leftover/scrap materials otherwise be disposed of?
 - b. How is scrap accounted for?

TAXPAYER:

DATE:

FORM/YEAR:

EXAMINER:

EXPENSES:

1. Are all expenses paid by check?
 - a. Are credit cards or cash ever used?
 - b. Who has authority to write checks? To authorize expenditures?
2. How and when are the expenses recorded?
3. Who records the expenses?
4. Is all drywall delivered to the job sites?
 - a. What are the time frames for ordering, delivery, and payment regarding drywall materials?
 - b. Who are your suppliers of drywall materials?
 - c. What payment terms do you have with suppliers?
5. How are purchase discounts accounted for?
6. What is your policy regarding employee and officer expense reimbursements?
7. What is your threshold amount for classifying an expense as a capital expenditure?

PAYROLL:

1. How often are employees paid?
2. Are all payments by check?
3. Who does the payroll?
4. If an outside service does the payroll, who prepares the records for outside service?

TAXPAYER:

DATE:

FORM/YEAR:

EXAMINER:

5. Do you carry workman's compensation insurance?
 - a. Was a workman's compensation audit done in the year of audit?
 - b. How are workman's compensation refunds accounted for?

DOCUMENTATION OF THE CONTRACTOR RELATIONSHIP:

1. How often do you use independent contractors and for what purposes?
2. Do you have written contracts with these workers?
3. Are Forms 1099 issued to all workers that you treat as independent contractors?
4. What type of records do you keep on independent contractors? Do you track dates, frequency of work, and compensation rates of independent contractors?
5. Have you received Forms W-9 from all independent contractors?
6. Have you received any correspondence from the IRS regarding Forms W-9?

NOTE: If the business does not meet the Section 530 reporting requirements for workers, explore whether the workers are independent contractors or employees. See the training materials, Training 3320-102, **supra**.

LOANS TO SHAREHOLDERS / CORPORATE ISSUES:

1. What is your policy on loans to or from shareholder? I note that you do list over \$_____ outstanding on your balance sheet as a loan (to) from the shareholder to the corp.
2. Are promissory notes available for my inspection? If not, why and what records do you have of these loans?
3. Who keeps the corporate minute book?
4. What classes and number of shares do you have outstanding?

TAXPAYER:

DATE:

FORM/YEAR:

EXAMINER:

5. Were any directors fees paid and to whom?
6. Were any dividends declared or paid?
7. How are the officers' salaries determined?

SPECIFIC ITEMS: