



## Market Segment Specialization Program



# Carpentry/Framing

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*.

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**Market Segment Specialization Program  
Carpentry/ Framing**

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## INTRODUCTION

USE OF THIS GUIDE: This is a supplement to the Market Segment Specialization Program's (MSSP) Construction Audit Technique Guide (ATG) and should be used in conjunction with the Construction ATG. This supplement is intended to be a reference for revenue agents and tax auditors in examining returns in the carpentry/framing subsegment, as defined below. Examiners should consult this material in both the planning and development phases of an income tax examination. The potential tax issues addressed may apply to proprietorships, partnerships, corporations, or S corporations.

**Audit techniques are shown throughout this supplement. These techniques may or may not be appropriate on any particular case. THE EXAMINER MUST USE PROFESSIONAL JUDGMENT WHEN APPLYING ANY OF THE TECHNIQUES DISCUSSED HEREIN.**

THE CARPENTRY/FRAMING SUBSEGMENT: The audit techniques described herein will apply primarily to small businesses engaged in remodeling, home improvement, carpentry, woodworking, framing, and residential building. Since these businesses must work closely with those in other specialty building trades, some aspects of this guide will apply to other trades in the construction industry.

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## Chapter 1

### INDUSTRY PRACTICES

#### THE CONSTRUCTION CYCLE

Generally speaking, the construction industry is characterized by a business cycle which is more pronounced than other market segments. The following extract from William D. Mitchell's *Contractor's Survival Manual* (Craftsman Book Company, 1986), Chapter 1, "The Basics of Construction Contracting," addresses this point:

#### EXTRACT

Every construction contractor should understand that there's a cycle of construction activity. This cycle rewards those that can anticipate it and punishes those that can't. The construction cycle can make or break you. And for many it does both.

At the beginning of every upswing in construction activity a fresh new crop of eager young builders surge into the industry. They develop a house or two, sell them off at a nice profit, and then tackle larger projects, making more money and laying bigger plans. After three or four very profitable years, some of these builders are running big construction companies with millions of dollars in assets and several major projects under way. They probably attribute their success to hard work, skill and daring. They're right. But they were also in the right business at the right time. And good times don't last forever.

When recession comes, as surely it will, hard work, skill and daring count for little. The bank loans, heavy investment in materials, equipment, staff, overhead and projects that can't be sold become a crushing burden. Many builders fail and leave the business. Others can salvage enough to remain active, or at least stay in business, until the next upswing comes.

Economic recessions are here to stay. There's no reason to suspect that our economy will be better managed or that recessions will be less severe in the future than they have in the past. Accept the ups and downs in construction activity as an opportunity to improve your competitive position against other contractors. Plan to survive when others can't, and thrive when others can only recover.

Exactly what is a recession? From a builder's standpoint, we're in a recession when construction activity is down. That's usually because owners can't borrow money or would have to pay interest rates that make borrowing unattractive. Nearly all construction work is done on borrowed money. When lenders stop lending, builders stop building. That's a recession.

The pronounced ups and downs of the construction cycle make some tax issues more common in this industry. Two such issues addressed in this supplement which may occur in corporate returns include officers' compensation (more likely to be unreasonably high in "good" times), and loans from pension plans (more likely to occur in downswings). Additionally, the examiner should be mindful of the construction cycle, or environment during the year under consideration since this may affect sales, profit margins, and other items appearing on the return.

## **SUPPLIERS' ROLE IN THE BUILDING PROCESS**

### **Contents of This Section**

- > The ratio of lumber/materials expense to gross income;
- > Suppliers' role in the construction process - lumberyards and retail warehouses;
- > Records maintained by suppliers and potential value to examiner.

### **The Ratio of Lumber/Materials Expense to Gross Income**

In many carpentry/framing businesses, lumber and other building supplies represent the most significant expense incurred by the company. This cost will usually be reported in the Cost of Goods Sold section of the tax return. The amount of this expense alone will often require that it be included in the scope of examination.

The ratio of lumber/supplies expense to gross receipts will vary based on the nature of the business. For example, the cost of materials may represent 50 percent or more of the total costs to build a standard home in a large housing development. Such homes are built in fewer hours as teams of workers move from house to house with only minor variation in plans or work procedures. Under these circumstances, labor, overhead, and other related expenses (per house) would represent a lower percentage of total costs; lumber and direct materials would represent a larger portion of total costs.

On the other hand, materials may represent as little as 25 percent of total costs to build one custom home designed by an architect to meet the needs of a particular customer. This home may involve more complex construction techniques and considerably more labor hours/costs than the standard home in a large development.

**AUDIT TECHNIQUE:** The examiner should determine the nature of the taxpayer's work (that is, standard or custom) to gauge the reasonableness of materials (or labor) as a percentage of gross receipts. Ratios which appear out of line may warrant more in-depth consideration. Part II(D) of this supplement provides guidelines for estimating the reasonable cost of materials and labor expense for framing contractors.



## **Suppliers' Role in the Construction Process - Lumberyard and Retail Warehouse**

Carpentry/framing businesses look to lumber and materials suppliers to obtain essential materials at the best possible prices. Cost, however, is just one factor a builder considers in selecting a supplier. In addition to cost, the following factors may influence a builder's use of a particular supplier:

- > Location
- > Quality of lumber and other building materials
- > Delivery services
- > Size of inventory available for immediate use
- > Extension of credit
- > Knowledgeable staff

Suppliers to carpentry/framing contractors generally consist of two types: lumberyards and retail warehouses. In general, a lumberyard and a retail warehouse compare as follows:

1. Cost: A retail warehouse will generally be less expensive due to volume and economies of scale. Lumberyards, however, commonly offer discounts to a contractor which would not be available to a noncontractor. Contractor discounts can be quite significant, particularly for high-volume buyers.
2. Location: The growth of building supply warehouses has dramatically increased in recent years, and most major metropolitan areas now have one or more such outlets. A close location does offer a convenience which any contractor would desire.
3. Quality: While this area may be subjective, most of the builders contacted in connection with this audit guide stated that lumberyards carry wood products of more dependable quality than warehouses. Exceptions will always exist, of course.
4. Delivery services: Both yards and warehouses deliver materials to the construction site. The quality and timeliness of the delivery will vary among suppliers. Many yards have emphasized delivery and other services to compete successfully with the lower priced warehouses.

5. Size of inventory: A yard will generally carry a wider inventory of lumber in hard-to-find sizes. For example, a yard could often deliver a 2" x 10" x 32' ridge beam to a job site in a relatively short time. On the other hand, a warehouse carries a much wider range of construction products and may be relied on for one-stop shopping to supply all the materials needed for a small job.
6. Extension of credit: Yards extend credit to contractors as an integral part of their business. Warehouses are less likely to do so. For small jobs, carpenters may finance purchases at a warehouse with a general credit card.
7. Knowledgeable staff: This is a subjective category and levels of expertise will vary among suppliers. Contractors interviewed in preparing this audit guide gave a clear advantage to the lumberyard, however. This perception may be influenced by the fact that warehouses are a newer form of business and often have more staff turnover. Lumberyard owners/operators usually have a significant amount of experience in the business and often stay well informed of all events in the local construction community. Yards are accordingly viewed as a reliable source of information and assistance.

A contractor may then rely on a lumberyard or a retail warehouse, depending on how heavily the factors above are weighed.

Generally, the larger business will establish a working relationship with one or more lumberyards to provide the bulk of their material needs. To meet the price competition from retail warehouses, yards have slimmed down, employ the "just in time" concept to keep inventory levels low, and use computers to manage their inventory, accounts payable, billing, and general operations. This has led to greater pricing flexibility by yards, which has produced the industry survivors we have today. Yards also provide detailed purchase records to the contractor when and if they are needed for job cost analyses. Yards often have one or more in-house staff members who work with builders on blueprint review or revisions, bill of material requirements, and the general requirement of pricing the job. Yards may extend credit into the tens of thousands of dollars and traditionally take an active role in the construction process.

A smaller operator, such as a self-employed remodeler, may find the warehouse to be a more convenient and cost effective supplier of a wide range of construction materials purchased on an as-needed basis. For example, in addition to lumber, a retail warehouse would carry a wide range of plumbing, electrical, flooring, painting, and other products as well as tools and adhesives.

**AUDIT TECHNIQUE:** Supplier relationships should be established in the initial interview to gain insights into the operation of the business. Suppliers can be valuable sources of information as explained later in this section.

## **Records Maintained by Suppliers - Potential Value to Examiner**

Interviews with suppliers revealed that while record keeping practices vary, nearly all maintained certain basic records for contractor accounts. These basic records are described below, with comments on potential use to the examiner. All of the lumberyards contacted retain records described below for a minimum of five years.

For discussion purposes, records are separated into two broad categories: permanent files and transaction files. Permanent files include information secured or maintained on credit accounts. A permanent credit folder will be established and updated for as long as a customer maintains a credit account. Transaction files document ongoing purchases, payments on account, account balances, etc., by year.

### **Permanent Credit Files**

A significant service offered by most suppliers is the extension of credit to carpenters/framers. Customary terms permit the builder to have materials delivered on account, and to make monthly payments on the liability. Standard terms provide for no interest charges on any purchases paid for within 30 days of delivery.

This arrangement allows the builder to initiate a construction project with a minimal up-front investment. Frequently, the terms of a construction contract will require the end customer to make progress payments to the builder as materials are delivered and applied. These terms allow the builder to make timely payment to the materials supplier and thereby avoid finance charges.

Before extending credit, a lumber supplier will evaluate the contractor's credit worthiness. Information the supplier secures will commonly include a credit application and related documents.

The amount of detail on a credit application will generally be based on the amount of credit desired. Many suppliers will secure a report from a credit bureau and retain the report in the contractor's permanent file. The application for credit generally asks for various information which may be of value to the examiner, including:

- > Location of applicant's residence and other real estate owned;
- > Mortgages;
- > Employer(s);
- > Ownership interests in partnerships or corporations;
- > Persons authorized to charge the account;

- > Bank and credit card accounts;
- > Loans outstanding;
- > Other credit references.

For active accounts, a supplier may ask the contractor to update the above information annually.

For larger projects or credit lines, a supplier may require audited financial statements attesting to the contractor's financial condition. The builder may also be required to secure a payment bond guaranteeing satisfaction of liabilities incurred. (See the MSSP Construction ATG for a discussion of bonding.)

### **Transaction Files**

Transaction files would generally include details of purchases, deliveries, merchandise returns and credits, payments on account, and finance charges. The extent to which these records are maintained and sorted by customer will vary by supplier. Many suppliers have automated record keeping, which facilitates the sorting of records by contractor, job number, or delivery site.

In cases where the need for supplier contact exists, the examiner should begin by determining what types of records the supplier maintains. Many suppliers record customer information only for purchases on account and do not record the identity of a customer making a cash purchase.

A supplier may be able to provide the following transaction records:

- > Account ledger card (account summary): lists the purchases on account, payments and credits, interest charges, and outstanding account balances.
- > Invoices: show the date and amount of a particular charge, job site or lot number, and an itemization of materials provided.
- > Delivery tickets: record the customer's receipt of materials. Tickets may itemize materials provided, date and delivery site, and the signature of the customer or representative acknowledging receipt.

**AUDIT TECHNIQUE:** Examiners should use professional judgment to determine if a third-party request to secure a taxpayer's credit application and other relevant documents is an appropriate audit technique. In general, the contact should be carefully considered in cases where one or more of the following factors apply:

- > Taxpayer cooperation is lacking or nonexistent;

- > Books/records are lacking or nonexistent;
- > Internal controls are weak;
- > The examination of other line items on the return reflect a pattern of noncompliance.

Potential issues to be developed based on the above records include:

- > Unreported receipts: Invoices and or delivery tickets may disclose a job site not appearing in the taxpayer's sales journal.
- > Undocumented labor: Delivery tickets may reveal that the person acknowledging receipt of materials is a worker for the taxpayer for whom Form W-2 or 1099 is not submitted. This development may indicate noncompliance, which would support expansion of the examination's scope and depth.
- > Unsatisfied liabilities: For an accrual basis taxpayer, liabilities which are unsatisfied for extended periods of time may warrant consideration of IRC section 461 and the all-events test (did all events take place to fix the liability?). An adjustment to materials expense may be pursued if the taxpayer accrued an expense but has no intention of satisfying the liability because of a dispute with the supplier.
- > Cash payments on account: If cash payments are reflected on the taxpayer's credit account, the examiner should determine if these payments represent income from a job(s) not reflected in the books and records.
- > Undisclosed bank accounts: The examiner should be alert for payments on account made with checks from an undisclosed bank account(s). In such instances, deposits to such account(s) should be considered in the testing of income.

Notwithstanding the above issues, the need to secure information directly from a supplier is a decision to be based on all facts and circumstances in the case. Some of the issues above can be identified by analyzing books and records provided by the taxpayer. Also, these issues are not intended to represent a complete list, but rather are provided as a reference point for the examiner.

When case circumstances warrant contact with suppliers, the examiner may first call the supplier to determine the nature of the records maintained and to determine if a summons or an informal request will suffice. A sample request for information is shown below.

While information provided by a supplier may prove valuable to the examiner, such information may not provide a complete picture of the taxpayer's transactions. Most suppliers of building

materials will be able to provide specific taxpayer information only with respect to credit transactions. In cases where suppliers are contacted, the examiner should determine whether the taxpayer's noncredit transactions (if any) are retrievable. The supplier may also be able to provide testimony about the existence of cash or noncredit transactions.

**Sample Request for Records From Construction Materials Supplier**

1. Credit applications, including all attachments and related documents
2. Financial statements
3. Credit agreements
4. Ledger cards or monthly statements showing account transactions
5. Details of sales transactions, including the dates and amounts of all sales, both cash and credit sales
6. Details of all payments, including the date, amount, and method of payment (cash or check)
7. Amounts of purchase discounts provided to the customer
8. Amounts of interest charged and paid each month
9. Details of liens filed on property owned by the customer
10. Records relating to any amounts the customer owes which have been uncollectible or written off as bad debts
11. Sales invoices and delivery tickets for all sales to the customer for the following months.

## **THE ROLE OF STATE AND LOCAL GOVERNMENT - LICENSES, REGISTRATIONS, AND BUILDING PERMITS:**

### **Licenses and Registrations**

The license/registration requirements for carpenters and their business entities (that is, sole proprietorship, joint venture, partnership, or corporation) vary from state to state. Most states, however, do require those in the carpentry/framing business to register or obtain a license.

Typically, a carpenter seeking to obtain a license or registration must fill out an application to do business in a particular state. Some states require applicants to take a test before granting a license. On being licensed or registered, the individual or business organization is typically granted a document which indicates the contractor's license or registration number.

A summary of the licensing/registration requirements for each state or jurisdiction is included in Appendix A. This summary lists the basic requirements for licensing in each of the 52 jurisdictions. Some contractors are exempt from these basic requirements. For example, most states do not require a license or registration for owners who improve their residences. To determine if a contractor should be licensed or registered in a particular state, the examiner should contact the state agency listed in Appendix A.

### **AUDIT TECHNIQUES:**

1. Contact the state agency in the jurisdiction(s) in which the carpenter does business. Ask if the agency has any reports or other information about the taxpayer from the year(s) under audit. At a minimum, the state agency will usually confirm the existence of an active license or registration. Many states receive and file complaints (for example, Department of Consumer Protection) against a contractor by dissatisfied customers. Inclusion of any such job(s) in income should be verified.
2. Determine the state and local town filing requirements for the contractor who is under examination. If the contractor is required to be licensed or registered with the state, the state agency may use this license or registration number for other purposes. The license/registration number may be used to tie into other filing requirements imposed by the state. These filing requirements may include:
  - a. Annual corporation permit fee
  - b. State income tax/corporate franchise tax
  - c. Local tax
  - d. Sales and use tax
  - e. Fuel tax
  - f. Property tax

If applicable, the examiner may be able to obtain copies of these returns through an information sharing agreement that the IRS has with that particular state.

### **Building Permits**

Contractors (including carpenters or their business organizations) are typically required to file an application for a building permit with the town or municipality in which they have contracted to improve real property. Building permits generally serve to ensure that construction work complies with structural, safety, and zoning standards. Nearly all towns employ a building inspector who will review building or remodeling plans and make on-site inspections to ensure that work is completed in accordance with local building codes. On satisfactory completion of the job, a homeowner will be provided a certificate of occupancy or certificate of completion.

Generally, building permit applications require among other things that the contractor list the cost of the improvement being made to the real property. A homeowner may apply for a building permit for work to be done on his or her property, even if a contractor is hired to complete the work. In such case, the contractor may not be listed on the permit.

Local government will also increase the assessed value of real property for taxing purposes based on improvements to that property. This fact may provide an incentive for one to understate the value of an improvement when completing an application for building permit.

Just as the licensing and permit requirements for each state and town may differ, the way each municipality files these documents is also different. Some states and towns may have fully automated filing and document generation and retrieval systems, while others may use a manual system.

### **AUDIT TECHNIQUES:**

1. Call or visit the building inspector in the town(s) in which the contractor does business. The inspector may be able to provide information about jobs done, specialties pursued, or associates with whom the contractor works. This technique may be particularly appropriate in cases where records are lacking or financial status is a concern.
2. Determine where the taxpayer does most business. Visit local town or municipal offices to search for building permits in which the taxpayer is shown as the contractor. Is it possible to get a printout of all permits for jobs completed by the contractor (via license or registration number) for a particular year? Maintenance of automated records will make this technique more feasible. If warranted, the assistance of a paraprofessional should be considered if records are not automated. Inclusion of any such jobs in income should be verified.



3. Inspect the underlying building permit for jobs disclosed in the taxpayer's records. Compare the value of the job as shown on the permit to the amount of income recorded in the books. Any discrepancy in which the amount on the building permit exceeds the amount of income recorded in the books should be investigated. A discussion with the taxpayer or customer may be warranted.

## **ESTIMATING LABOR AND MATERIALS FOR FRAMING CONTRACTOR**

Framing is the process of constructing the shell of a building and includes those components shown in Figure 1-1 below. A frame does not include the foundation, windows, doors, siding, drywall, interior molding, or roofing shingles.

This section is divided into three components:

1. Estimating framing labor costs
2. Estimating framing materials costs
3. Possible explanations for a variance, and potential audit techniques to address a variance.

**CAUTION:** The techniques set forth in this section should not be relied on as a basis for supporting an adjustment to a filed return where books and records are available. The technique is an indirect estimate applied to adjust the depth of examination for labor or materials expenses. Also, the formulas and estimates in this section are subject to numerous exceptions. The techniques in this chapter should be applied only after careful consideration of the time required to complete any analysis.

**AUDIT TECHNIQUE:** This section presents an audit technique that can be used to determine if labor or materials expenses claimed for a particular framing job are "reasonable" in relation to industry standards. **THESE TECHNIQUES ARE APPLICABLE ONLY TO THE WOOD FRAMING OF A NEW BUILDING OR THE FRAMING OF A NEW ADDITION TO AN EXISTING BUILDING.**

This technique may prove worthwhile under the following circumstances:

- > As a preliminary test check. Should the test check indicate that labor and or materials expense claimed by the taxpayer are in line with the examiner's estimate, the "depth" of audit for this item may be contracted. If the test check indicates that labor expenses claimed is not in line with the examiner's estimate, additional audit procedures may be warranted.
- > To reconstruct expenses for a nonfiled return.

- > To reconstruct expenses for a filed return when cooperation or books and records are lacking.

## **1. Estimating Framing Labor Costs**

Details below set forth methods to estimate standard labor costs to frame a new home with 1,000 square feet of living space. It is important for the examiner to understand these methods because adjustments may be necessary to reflect regional labor rates and the effects of inflation. The following concepts must be addressed to apply this technique:

- > Worker hours required to frame 1,000 square feet of living space: This is the total hours required by a skilled carpenter to frame a basic structure of this size.
- > Hourly labor cost: This includes the basic wage, employer's contribution to welfare, pension, vacation, apprentice funds, and all tax and insurance charges for a skilled carpenter.
  - a. WORKER HOURS: The handbook *Carpentry Estimating*<sup>1</sup> was relied on to arrive at applicable estimates. Figure 1-1 below itemizes the components included in a typical framed structure along with the worker hours necessary to measure, cut, and install the wood for that component in the structure. These estimates should remain constant from year to year unless new framing techniques are developed. As shown in fig. 1-1, it takes a skilled carpenter about 221 worker hours to frame a 1,000 square foot (SF) building. An example of how this information may be used in a specific case will be given later.

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<sup>1</sup> W. P. Jackson, *Carpentry Estimating* (Craftsman Book Co., third printing, 1994).

FIGURE 1-1

<u>Framing component</u>	Worker hours per 1,000 SF of <u>floor space</u>
Sills, per blocks, floor beams	16
Floor joists, blocking, bridging	26
Subfloor, plywood	10
Studs, plates, headers, blocks, bracing	80
Wall sheathing, plywood	13
Ceiling joists, beams, trimmers, blocks	36
Rafters, collar beams, ridge boards	26
Roof sheathing, plywood	<u>14</u>
Total hours to frame 1,000 SF of floor space (est.)	221

- b. HOURLY LABOR COSTS: The hourly framing labor costs will vary from year to year and from state to state. Below are details used to compute the Connecticut hourly labor cost of \$29 for 1995. This cost was arrived at using the *National Construction Estimator*.<sup>2</sup> The hourly labor cost of a Connecticut carpenter is computed as follows:

25.46 Price per hour for a building carpenter  
x1.12 Area modification factor for Bridgeport, CT  
 28.51 Total carpenter labor cost per hour (est.) for 1995 in the Bridgeport, CT, area (rounded to \$29)

A new edition of the *National Construction Estimator* appears each year and can be obtained at your local library to secure details for years other than 1995. This reference may be particularly useful when reconstructing the income of a nonfiler, or in the case of a filed return but a lack of adequate books and records.

When considering a return which includes carpenter costs and adequate records are provided to the examiner, a more accurate way to determine the hourly labor cost is to look at applicable payroll records for actual data. Note, however, that labor rates set forth in the *National Construction Estimator* include all benefits. Accordingly, the examiner would have to add

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<sup>2</sup> Martin D. Kiley, *National Construction Estimator* (Craftsman Book Co., 43rd ed.).

employment taxes, health insurance, and the other identified applicable benefits so that the wage expense estimated in the audit is computed on the same basis as shown in the reference book.

Note that in an examination of a sole proprietor who does not claim labor costs, it would be appropriate to estimate material costs only since a fair labor charge should be reflected in the net profit on Schedule C.

To compute the average hourly labor costs per SF of framing, the information above is used as follows:

Work hours to frame 1,000 SF of living area (est.)	221
Carpenter's labor rate per hour (est.)	<u>x \$29</u>
Labor cost to frame 1,000 SF of living area (est.)	\$6,409
Divided by number of SF framed	<u>1,000</u>
Cost of labor per SF of framing (est.)	\$ 6.41

The number arrived at is an industry average of the carpenter's labor cost to construct 1 square foot of residential living space in the Bridgeport, CT, area during 1995. To use this information, multiply the hourly rate by the number of square feet of living space framed by a carpenter for either the entire year or for a specific job. This will give you an estimate of the labor cost which should have been incurred for the project(s).

A reasonable error factor is deemed to be 10 percent. If actual labor charged on the return is within 10 percent of the estimated amount, further inquiry may be limited. The scope and depth of each audit must be based on all facts and circumstances, however. If labor costs charged exceed the estimate by more than 10 percent, additional testing may be warranted. Application of this technique is shown in the following example.

#### EXAMPLE 1:

A review of contracts shows that two houses were framed, with each home consisting of 2,000 SF. Using the formula provided above, you estimate the cost of labor (framing only) at \$25,640 (4,000 SF x \$6.41 labor per SF). Review of the taxpayer's job cost file shows framing labor expense of \$38,750 for these jobs. A 10 percent error factor is added to the labor estimate, bringing it to \$28,204. Actual labor charged exceeds the estimate by \$10,546, which is significant enough to warrant further consideration of this expense.

## 2. Estimating Framing Materials Costs

Two key components are needed to estimate the standard industry costs to frame a structure: Amount of wood used and costs of wood. While the amount of wood needed to frame a standard structure is fairly consistent nationwide, costs will vary from region to region.

Figure 1-2 computes the costs of wood to frame 1,000 square feet of floor space. By dividing the total material cost amount shown in column D by 1,000, we arrive at the cost of material per square foot.

FIGURE 1-2

COSTS OF WOOD TO FRAME 1,000 SF OF FLOOR SPACE:

Framing component	(A) Lumber per 1,000 SF of floor	(B) Lumber and plywood sizes	(C) National avg. material prices on 1/1/95	(D) [A x C] Extended cost of material
Sills	44 BF	2"x6"	\$575 MBF	\$25
Floor beams, joists, headers, ceiling joists, ridge beam	3,025 BF	2"x10"	\$710 MBF	\$2,148
Subfloor, wall and roof sheathing	3,600 SF	1/2"x4'x8' CDX	\$451 MSF	\$1,624
Studs, plates	1,800 BF	2"x4"	\$585 MBF	\$1,053
Rafters	1,246 BF	2"x8"	\$610 MBF	\$760
Bracing and misc.	110 BF	Various	-	\$300*
Blocking and bridging	50 BF	Various	-	\$155*
Total costs of material to frame 1,000 SF of floor space on 1/1/95 in Bridgeport, CT (est.)				\$6,065

\* The various requirements have been converted to an estimated dollar amount.

(A) "Lumber per 1,000 SF of floor" provides the lumber and plywood requirements in BF (board feet) and SF (square feet) for each framing component.

(B) "Lumber and plywood sizes" are national standardized building requirements for lumber sizes.

(C) "National avg. material prices on 1/1/95" were obtained from *Means' Repair and Remodeling Cost Data 1995* (Kingston, MA, R.S. Means Co.)

These prices should be updated for the years under consideration. *Means' Repair and Remodeling Cost Data 1995* (Kingston, MA, R.S. Means Co.) provides national price figures and average prices for 30 cities. The extract below explains computation of lumber volume in terms of board feet.

### EXTRACT

From: W.P. Jackson, *Carpentry Estimating* (Craftsman Book Co., third printing, 1994), Chapter 2, "Estimating Rough Carpentry"

The cost of lumber is higher for thick and wide planks than for thin and narrow ones. Lengths longer than 16 or 20 feet may require special orders. Unless you request otherwise, the yard will usually quote lumber prices for random lengths to 20 feet. Longer pieces and specified lengths will cost more.

Lumber is sold by the board foot. A nominal 1 x 12 board that's 12 inches long has one board foot. A nominal 2 x 6 that's 12 inches long also has one board foot. The term is abbreviated BF. Here's a quick way to figure the number of board feet in any length of lumber: Write the nominal dimension (width and thickness in inches, length in feet) over 12 in the form of a fraction. Then reduce the fraction to get the board footage. For example, figure the board feet in a joist 2 x 8 x 16' long:

$$\frac{2 \times 8 \times 16}{12} = \frac{256}{12} = 21\text{-}1/3 \text{ bf}$$

When figuring more than one piece, simply multiply the board footage in one piece by the number of pieces. For example, if there are 40 joists 2 x 8 x 16', the number of board feet would be:

$$\frac{40 \times 2 \times 8 \times 16}{12} = 853 \text{ bf}$$

Guidelines for estimating the costs of framing materials follow, along with an example of its use.

The formula to estimate framing material costs is: Cost of material per square foot x square foot framed = Total cost of material (est.).

The cost of material per square foot will vary with the year considered and the region in which the framer works. Figure 1-2 above illustrates that the national standard costs to frame 1,000 SF of floor space totals \$6,065. Dividing this amount by 1,000 yields a cost of material per square foot of \$6.07.

The examiner may estimate costs for one job, a series of jobs, or any reasonable combination.

### Tips on Securing Necessary Information:

Lumber Prices: To secure realistic material prices for the period(s) under audit, the examiner can look to the information provided in exhibits to this supplement. These exhibits reflect pricing trends on January 1, 1995. When considering other time periods, pricing information may be estimated by reference to the following:

- > Review taxpayer purchase records for the prices charged for various types of lumber.
- > Refer to a copy of the *Means' Repair and Remodeling Cost Data* for the year under consideration. This reference should be available in most public libraries.
- > Use estimates provided by the taxpayer.
- > Contact local lumberyards for pricing information.

### Number of Square Feet Framed:

The examiner must determine the total square feet framed by the taxpayer for a particular job or series of jobs. This information can be obtained from contracts, job cards, or blueprints provided by the taxpayer. Alternative sources may include building permits, interviews with the homeowner/customer, or discussions with the taxpayer.

#### EXAMPLE 2:

The taxpayer is a home builder in a New England state. During the year 1994/95, the taxpayer's records reflect that in addition to other jobs, the company was engaged as a subcontractor to frame 17 homes in a housing development. The examiner confirms with the taxpayer that finish carpentry work was not provided on any of these homes. Review of the contract reveals that each home consisted of 2,000 square feet of living space. Review of taxpayer job cost files indicates that total lumber costs charged on the books for this project was \$211,000.

Figure 1-2 above estimated material prices for this time period and location at \$6.07 per SF. Our total cost estimate to frame 34,000 SF is \$206,380 ( $\$6.07 \times 34,000$ ). It is reasonable to conclude that lumber costs charged (\$211,000) are in line with our estimate (that is, within 10 percent) and that additional consideration of this cost will be limited.

Let's assume that material costs charged to this project totaled \$272,000. This amount exceeds our estimate by \$66,000 (32 percent). This discrepancy does not necessarily



mean that the return is inaccurate, but additional consideration of this cost may be warranted. The final section of this chapter sets forth potential reasons for a discrepancy, and suggests appropriate examination steps to address discrepancies.

### **3. Possible Explanations for a Variance/Follow-up Audit Techniques**

A finding that the labor or materials expense charged on the return (of a framer) exceeds the examiner's estimate may be due to the following:

- > Gross receipts are understated. Additional testing of income may be warranted.
- > The expense claimed for labor or material is overstated. This would necessitate expanding the depth of audit for these items to include an analysis of source documents, such as cancelled checks, invoices, payroll records, delivery tickets, etc. Contact with the worker or materials supplier to verify the authenticity of the transaction may be appropriate, depending on the case facts and circumstances.
- > The job was more difficult or costly than the taxpayer anticipated. A discussion with the taxpayer may be useful.
- > The taxpayer is not a skilled framer and generated excessive waste material. Perhaps the taxpayer (or work crew) is inexperienced and still learning the trade.
- > Lumber was stolen from the job site. If significant, the taxpayer may be able to support this with a police report.
- > Labor and or materials expense charged to the job(s) may have been applied to a different job(s). The strength of internal controls should be considered. Also, the possibility that expenses were diverted to an unreported job should be considered. Third-party contacts or a discussion with the taxpayer may be useful, depending on case facts and circumstances.
- > The taxpayer's activities went beyond standard framing to include finish carpentry work or other tasks necessary to build a home. A discussion with the taxpayer to clarify this point may be helpful. The examiner may also want to review the contract(s) for the work in question to determine the nature of the services provided.
- > Another technique to consider when an estimate for labor or materials is substantially less than the amount charged is to discuss the discrepancy with the taxpayer and ask for possible explanations. Perhaps the cost of lumber, amount of lumber, or hours devoted to a particular job were much higher than the estimate due to factors peculiar to that job. Data provided as the basis for estimates (labor

hours, volume of wood) assumes a "standard" method of architecture. A more complex or custom method of architecture would result in a higher labor and materials cost. If this is the case, however, gross receipts from the job should reflect the additional expense incurred by the framer, and a positive gross profit should be realized.

## **METAL FRAMING**

Metal framing has increased in popularity in recent years. When the cost of lumber increases, metal products may be increasingly looked on as an alternative. Suppliers of metal framing products now provide training at various sites around the country. In addition to possibly lower costs, there are several differences between metal and wood. Some of the advantages and disadvantages are as follows:

Advantages:

1. Metal is stronger and lighter.
2. Since metal is much stronger than wood, a builder may use less of it to frame a whole house.
3. Termites and other insects will not destroy metal.
4. Metal is more resistant to fire damage, earthquakes, and hurricanes.
5. Metal products do not rot.
6. Consistent dimensions mean straighter, stronger walls and floors.
7. Metal products are cut to length, thereby reducing waste.
8. Environmentally friendly; easy to recycle or reuse. Saves trees and wildlife.

Disadvantages:

1. Metal products may rust.
2. With steel studded walls, insulation is more difficult.
3. Metal framing is viewed as a new trend. Many builders and their customers prefer the traditional qualities of wood.

4. The use of metal for framing requires special skills. Most carpenters/framers have little or no experience working with metal.

Examiners should be aware that carpenters/framers may use metal framing products in lieu of wood. In fact, because of the advantages and disadvantages of steel framing, a combination of both wood and metal products may be used in the framing process.

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## Chapter 2

### GROSS INCOME AUDIT TECHNIQUES

#### FOLLOW THE MONEY

According to the IRS Research and Analysis Division, the level of voluntary compliance in the carpentry segment is less than 75 percent . Failure to comply with employment tax and information return requirements often results in unreported income, the primary element of noncompliance. One technique for identifying employment tax noncompliance or unreported income is called "Follow the Money."

This method requires the examiner to look beyond the return under audit to focus on jobs or construction projects. The following simplified example illustrates this technique:

John and Jane engage a general contractor (GC) to build a personal residence for them at a cost of \$160,000. The GC subcontracts the job as follows:

Total job cost .....	\$160,000
Excavation/foundation	\$15,000
Carpenter/framer	\$50,000
Electrical	\$20,000
PH&A/C	\$25,000
Roofing/flooring	<u>\$20,000</u>
Total subcontracting cost .....	<u>\$130,000</u>
General contractor's gross profit .....	\$30,000

The job-based approach will require consideration of the following techniques, each of which is explained below:

**1. Verify that the GC filed all required Forms 1099:**

The AIMS command PMFOL will generate a listing of Forms 1099 filed by the GC. It has been found that GC's sometimes do not provide noncorporate subcontractors with accurate and complete Forms 1099 because the GC does not secure the required Form W-9. Noncompliance may also result when the voucher system is used for paying subcontractors (the employment tax section of the Construction ATG addresses the voucher system).

If required Forms 1099 are not issued, backup withholding under IRC section 3406 should be considered. Consideration should also be given to initiating an examination of the recipient's return, or completion of Form 4536, Examination Information Report.

2. **Inspect subcontractor returns:**

Subcontractor returns, both corporate and noncorporate, should be inspected to verify filing, and to consider the potential for gross income or employment tax issues. AIMS command codes RTVUE (1040) and BRTVUE (1120, 1120S, 1065) may be used for this purpose.

- a. **Analyze gross receipts:** Subcontractor returns should report gross receipts from construction activities equal to or greater than the amount received from the GC. Consideration should be given to other transactions (jobs) completed during the year in which the GC engaged the subcontractor. Judgment must be used by the examiner when considering the possibility of unreported income on the subcontractor's return.
- b. **Analyze labor expense:** In most cases, the subcontractor will engage workers to complete the job. Inspection of the subcontractor's return should indicate whether workers are treated as contractors or employees. Again, a PMFOL will provide information on Forms W-2 and 1099 filed by the subcontractor. Continue to follow the money by inspecting recipient returns whenever Forms W-2 are *not* filed.

Based on the facts in your case, consider expanding the audit to any subcontractor for consideration of gross income or employment tax issues.

In the illustration above, the "money is followed" until Forms W-2 are identified for workers on a job or project, or a small business is identified which reports the income in question. This technique has been used in the Portland (timber industry) and Anchorage (fishing industry) Districts to uncover noncompliance.

The use of professional judgment is essential when determining if a participant in a construction project has audit potential. Examiners should consult their group managers when evaluating the circumstances in their case.

## **FINANCIAL STATUS**

Financial status audit techniques should be used only in situations where there are reasonable indications that there is unreported income. Examiners are cautioned that the below techniques should not be routinely applied in all cases. Instead, these techniques may or may not be applicable, based on all case facts and circumstances. As with all techniques in this supplement, the use of professional judgment is essential when deciding on examination scope and depth.

In analyzing a taxpayer's financial status, an examiner must determine if the income reported on the return is sufficient to support the taxpayer's lifestyle. In the case of a corporate or partnership return, the agent must look to the shareholders' or partners' individual returns to determine if the income reported from the related entities is sufficient to support the lifestyle of the individual(s). If preliminary facts indicate that the taxpayer is "living beyond his or her means," the examiner should give further consideration to the possibility that the taxpayer under-reported gross receipts. The following audit techniques may be used to help uncover possible unreported income:

1. Consider receipt of cash for jobs performed during the year. If the taxpayer does receive cash, the examiner should determine if all cash was deposited to the business bank account and recorded in the cash receipts journal.
2. In the initial interview, determine the list of suppliers used by the taxpayer. Compare the names on the list with the cash disbursements journal. If the supplier's name does not appear in the cash disbursements journal, consider contacting the supplier to determine if supplies were purchased with cash but not recorded in the books and records (if cash purchases are not booked, it is likely that the related receipts were not booked). If the taxpayer has taken a deduction for these supplies, make sure that gross receipts includes the cash used to purchase these supplies.
3. Review contracts, ask the taxpayer, or both about the type of jobs that were performed during the year. Review the invoices and receipts for materials and supplies purchased during the year. Note all delivery locations on these receipts. Were all the materials and supplies purchased during the year traceable to jobs performed during the year? The taxpayer may be deducting expenses for materials or supplies purchased for personal use, or which were applied to a job for which income was omitted.
4. During the interview, ascertain if the taxpayer has recently applied for any loans or mortgages. Loan applications may provide valuable information regarding the taxpayer's financial status (that is, bank accounts, assets, etc.).

5. Analyze all business and personal bank accounts. Have business receipts been deposited to these accounts? Have transfers been made to other (undisclosed) accounts? Note any excess deposits and reconcile the discrepancies. In addition, look at checks which were written on these accounts. Note any unusual payees. While inspecting checks, an examiner should also note certain required expenditures that are not being paid by check (that is, mortgage payments, car payments, education costs, utilities, groceries, etc.). These payments may have been made in cash.
6. Since carpenters are often selected by a homeowner based on a referral from a satisfied neighbor or acquaintance, a known customer may be able to provide the names of others who have hired the carpenter. Inclusion of any such jobs in income should be verified. The examiner must apply professional judgment when deciding if this type of third-party contact is appropriate.
7. Other gross income techniques set forth in this supplement should be considered. These may include contact with trade associates, building inspectors, or relevant state agencies. Any of these third parties may be able to provide leads to undisclosed jobs worked by the taxpayer.
8. Consider analyzing the taxpayer's gasoline charge account statements, if applicable. The fact that gasoline was charged at a particular town or location may indicate a job performed in that vicinity. Should this develop, follow-up techniques may include a discussion with the taxpayer, the applicable building inspector, or a search of building permits in that town.

### **KNOW ONE'S BUSINESS ASSOCIATES**

Participants in the construction industry frequently establish relationships in which jobs are referred to one another on a recurring basis. This is particularly true among small developers, home improvement contractors, and carpenters. These relationships may be a source of valuable information when testing receipts or reconstructing income.

#### **EXAMPLE:**

Jack and Judy Brown need to remodel an unfinished basement to use as office space. They note numerous advertisements placed by home improvement contractors in the local newspaper. Several bids are secured before the Browns decide to place the job with ABC Construction Co.

Andy, the owner of ABC, usually works alone and does not carry any workers or assistants. His expertise is carpentry. Andy's bid included estimates for the plumbing



and electrical work. He explains to the Browns that according to state law, the plumbing and electrical work must be performed by individuals licensed in these disciplines. Andy states that he knows a good plumber and a good electrician, and the Browns agree to use them.

On reviewing the job, the plumber and electrician modify Andy's estimate slightly. The Browns agree to the price adjustments, and the job is completed in excellent fashion.

The scenario described above is a common practice on small remodeling jobs, additions, or single family homes. The pooling of talents needed to complete the project may be accomplished in the following ways:

- > Construction company as general contractor (GC): The GC is responsible for the selection of subcontractors, and completion of the entire job. The GC bills the customer for all costs and is responsible for paying subcontractors.
- > Homeowner as general contractor: In this case, the homeowner would solicit bids and select participants for each major portion of the job. Acting as his or her own subcontractor, the homeowner may have the added burdens of coordinating work schedules, securing permits, and monitoring each contractor's performance.

In the example above, a carpenter, electrician, and plumber could complete the job. On larger construction projects, it may be necessary to engage subcontractors for architecture, engineering, excavation, concrete, flooring, painting, roofing, and landscaping. In areas without a municipal water supply, well-drilling and septic system subcontractors may be needed.

**AUDIT TECHNIQUES:** Assume that you are assigned to audit the ABC Construction Co. described in the example above. Assume also that in preaudit of the return, the reported sources of funds appear insufficient to satisfy business and personal expenditures, and that an in-depth income probe is appropriate. The following audit techniques should be considered:

1. In the initial interview, determine the extent to which the taxpayer accepts jobs as a general contractor or as a carpentry subcontractor. Ask the taxpayer to identify the tradespeople from other construction disciplines who work on common jobs. Does the taxpayer frequently use the services of specific subcontractors? Does the taxpayer receive a large amount of work from one or a few larger general contractors?
2. In reviewing books, records, or construction contracts, be alert for and note transactions with other tradespeople.
3. If concerns about potentially unreported income are not satisfied, consider contacting those tradespeople who work jobs with the taxpayer to secure a listing

of all such common jobs worked during the year(s) under examination. Since associates may be reluctant to disclose this information, the use of summons or affidavit procedures should be carefully considered.

4. Information obtained using the above technique may identify project(s) completed by the taxpayer which were not recorded in the books and records.

## **WITHDRAWALS FROM PENSION PLANS**

The construction industry is driven by large amounts of money loaned to continue existing projects and start new ones. When the construction cycle turns downward, many builders have difficulty satisfying creditors. Corporate builders may look to many sources for capital, including lending institutions, private lenders, new customers, shareholders or share owners, or, in some instances, corporate pension plans.

This section will review the tax law applicable to transfers out of corporate pension plans. While this issue might apply to a corporation engaged in any business activity, it may be more common within the construction segment due to the significant capital requirements of this industry.

Plan administrators invest and account for the funds in corporate pension plans. To obtain a loan from a pension plan the participant must complete a loan application. One factor distinguishing a pension loan from a commercial loan is that for the former, the plan participant is not required to demonstrate the ability to repay the loan. Accordingly, financial statements are generally not submitted with the loan application.

Owners may view the corporate pension plan as a source of significant capital with no immediate use. When borrowed properly, loans from a pension plan may have attractive interest rates and flexible payback features. Pension plans are sometimes the only source of cash when the construction company's financial condition is such that loans cannot be secured from other sources. Plan administrators will generally limit loans to contributions by the participant (shareholder) plus investment earnings, but will not lend a corporation's matching contributions. If the plan is not funded by the corporation, loans are usually limited to 80 percent of the funds credited to an employee's account.

Participants obtaining a loan agree to regular repayments to the pension plan. Since individual participants (not the corporation) secure the loans, any loan balances will not be reflected on the corporate balance sheet. When a shareholder borrows money from the plan and then loans it to the corporation, however, it would generally be accounted for as loans from shareholders. Alternatively, such a loan to a corporation might be reflected as a short- or long-term liability.

The Internal Revenue Code sets forth specific guidelines relative to loans from corporate pension plans. Failure to follow these rules may result in a significant tax impact on the recipient.

## **LAW**

Section 72(p) of the Code generally provides that an amount received as a loan from a qualified employer plan by a participant or beneficiary is considered as a distribution from the plan for purposes of IRC section 72 (a deemed distribution), except to the extent certain conditions are satisfied.

Under IRC section 72(p), a loan from a qualified employer plan to a participant or beneficiary is not treated as a distribution from the plan if the loan satisfies certain requirements relating to the terms of the loan and the repayment schedule, and to the extent the loan satisfies certain limitations on the amount loaned. Proposed regulations IRC section 1.72(p)-1 require that the loan be evidenced by an enforceable agreement, set forth in writing or in another form that is approved by the Commissioner of Internal Revenue, which includes terms that satisfy the statutory requirements. Thus, the agreement must specify the amount of the loan, the term of the loan, and the repayment schedule. The agreement may be set forth in more than one document.

If a loan fails to satisfy the repayment requirements or the enforceable agreement requirement, the proposed regulations provide for the balance then due under the loan to be treated as a distribution from the plan. This may occur at the time the loan is made or at a later date if the loan is not repaid according to the repayment schedule. If the loan satisfies the repayment requirements and the enforceable agreement requirement, but at the time the loan is made the amount of the loan exceeds the statutory limitation on the amount permitted to be loaned, the proposed regulations provide that only the excess amount is a deemed distribution.

One of the repayment requirements is that the loan be repaid within 5 years, unless the loan is used to acquire a dwelling unit which within a reasonable time is used as the principal residence of the participant. The proposed regulations provide that a principal residence has the same meaning as under IRC section 1034 (relating to the taxation of a sale of a residence) and that tracing rules established under IRC section 163(h)(3)(B) (relating to interest deductions for indebtedness incurred with respect to the acquisition of a principal residence) will be used to determine whether the IRC section 72(p)(2)(B)(ii) exception to the 5-year repayment requirement applies. (Notice 88-74, 1988-2 C.B. 385, sets forth certain standards applicable under IRC section 163(h)(3).)

The Tax Reform Act of 1986 amended IRC section 72(p) to require that, in order for a loan not to be treated as a distribution, the loan must be repaid in substantially level installments (not less frequently than quarterly) over the term of the loan. IRC section 72(p) authorizes regulations to allow exceptions from this requirement. Pursuant to this authorization, the proposed regulations permit loan repayments to be suspended during a leave of absence of up to one year if the participant's pay from the employer is insufficient to service the debt, but only if the loan is repaid by the latest date permitted under IRC section 72(p)(2)(B).

If a loan's repayment terms are not satisfied after it has been made because of a failure to make a scheduled loan repayment, the proposed regulations provide for the balance then due under the loan to be deemed to be distributed. The proposed regulations permit a grace period, to the extent the grace period does not extend beyond the end of the calendar quarter next following the calendar quarter in which the repayment was scheduled to be made.

If a loan is treated as a distribution under IRC section 72(p), the proposed regulations state that the amount so distributed is to be treated as a taxable distribution, subject to the normal rules of IRC section 72 if the participant's interest in the plan includes after-tax contributions (or other tax basis). A deemed distribution would also be a distribution for purposes of the 10 percent tax in IRC section 72(t) and the excise tax on excess distributions under IRC section 4980A.

#### **AUDIT ISSUE:**

Determine whether the shareholder of an incorporated construction company has borrowed funds from a qualified pension plan greater than the amount allowed under the Code sections above. Loans greater than the allowable amount will result in additional taxable income on the recipient's Form 1040.

#### **AUDIT TECHNIQUES:**

1. Discuss the pension plan, when applicable, during the initial interview. Ask if any loans were made by the plan during the year under examination and other years. Affirmative responses should be developed according to the tax law cited above.
2. In every corporate examination in which a deduction is claimed for contributions to a pension plan, IRM 45(10)1 sets forth minimum techniques. This includes completion of Form 4632-A, Employee Plans Referral Checksheet.
3. When inspecting Pension Returns, Form 5500EZ (one participant) or Form 5500C (2 to 100 participants), be alert for loans made by the pension plan which may not be clearly disclosed on the pension returns.
4. If liability accounts are included in the scope of an audit, be alert for loans originating from the corporate pension plan.
5. If loans from shareholders are included in the scope of examination, determine the shareholder's source of funds to supply the loan.
6. When applicable, make referrals to the Employee Plans Division for assistance. Also, the examiner should not hesitate to informally consult an employee plans specialist (if a referral is not required), to clarify any concerns which may exist.

## **OTHER POTENTIAL SOURCES OF INCOME**

### **Inspection or Insurance Appraisals**

Many customers will hire knowledgeable professionals to perform services closely related to their normal trades. Two of the more common services that may be provided by carpenters or framers are inspections and insurance appraisals. A potential home buyer may hire a contractor to inspect a house to determine the following:

1. structural integrity;
2. repairs necessary (if any);
3. presence of asbestos;
4. termite damage; or
5. renovation or remodeling potential.

Carpenters may also perform insurance appraisals. For example, if a homeowner has experienced damage to his or her home, a carpenter can estimate what the cost will be to restore the portion of the home that was damaged.

During the initial interview, the examiner should ask the taxpayer about other sources of income such as insurance appraisals and inspections.

### **Add-Ons (Weekend and Seasonal Work)**

Carpenters and framers may have many opportunities to do small jobs in their time off and on weekends. These small jobs may produce significant income for contractors. Some of these odd jobs may include:

1. Upgrades or add-ons to a "standard" home, such as storm doors, walkways, wood stoves, door openers, lighting fixtures, tile, carpet, or landscaping.
2. Improvements inside (for example, refinishing basements, hardwood floors, cabinets, wallpapering, painting).
3. Constructing sheds or other detached structures.
4. Decks and porches.

The jobs mentioned above are some of the more common ones. Often, the carpenter will receive cash for these small jobs. An examiner would most likely uncover income received from these jobs by performing financial status audit techniques and making third-party contacts.

**ACCOUNTS PAYABLE:** A contractor who uses the accrual method of accounting may incur expenses at one time and pay for them at a later date. These expenses would be classified on the balance sheet as accounts payable or another liability account. While conducting an examination, an examiner should review the accounts payable and look for amounts that have been on the books for more than one year. These unpaid liabilities may constitute income in accordance with IRC section 61(a)12. See the section below on "Income from Discharge of Liability/Bad Debts Deduction" for additional comments on this potential issue.

**SCRAP SALES:** Carpenters who remodel the homes of wealthy customers sometimes replace appliances, doors, windows, cabinets, or other home components based on the customer's fashion or design tastes. These components may be removed and retained by the carpenter, and may have substantial resale value. If applicable, the examiner should ask questions, or review contracts to develop the value of any such goods received. Consideration should be given to the potential sale of such items for cash. This issue may be more common in resort areas where second homes are owned, including shore communities and ski areas.

**INSURANCE REIMBURSEMENTS:** In areas where a casualty has occurred (for example, hurricane), carpenters may secure many jobs to repair damaged real estate. Remuneration for such work may be directly from insurance companies. These transactions are often completed on terms which are unlike a carpenter's normal business methods. For example, an insurance company may purchase the supplies and pay the carpenter only for labor. If applicable, the examiner should discuss the handling of any such unusual transactions with the taxpayer. If applicable, consider contact with the insurance company to verify payments.

**SNOW PLOWING:** Small contractors may plow snow during winter months to supplement income during a slow period. Indications of such activity may be found on the depreciation schedule or when touring business premises. Consideration should be given to addressing this potential source of income during the initial interview. Some municipalities use contract plowers to clear streets. This activity could generate significant income.

## Chapter 3

### OTHER EXAMINATION ISSUES

#### **ISSUES RELATED TO NONPAYMENT OF LIABILITIES: INCOME FROM DISCHARGE OF INDEBTEDNESS/BAD DEBTS DEDUCTION**

Several characteristics of the carpentry/framing market segment result in nonpayment of debts at a rate which generally exceeds that in other industries, including the following:

- > The construction or improvement of real property is expensive. Nearly all jobs are completed with borrowed money.
- > The construction of a home involves numerous products, services, and participants. Funds are commonly allocated to a dozen or more contractors and subcontractors who, in turn, compensate workers participating in the job.
- > Entry into the carpentry segment is easy in relation to other industries. A person with a basic knowledge of construction techniques, a few tools, and a license can advertise as a "contractor." However, the ongoing operation of a profitable construction company is something that many new participants never achieve.
- > The industry is subject to economic peaks that are generally more pronounced than in other segments. For example, when times are "good" (low interest rates, high employment, expanding economy) the demand for contractors may temporarily exceed supply. During these times, additional companies form to meet the demand and, hopefully, make a few dollars.
- > Economic downturns in the carpentry/framing segment are also more pronounced than in most industries. When times are "tough" (high interest rates, contracting economy) building activity nearly stops. During these times, many in the industry find themselves with jobs under way without the financial resources to complete the work.

The factors above result in nonpayment of liabilities within the construction segment at a more frequent rate than in other industries. This section will address two potential tax issues related to nonpayment of liabilities.

## **Income From Forgiveness of Indebtedness**

The unpaid debts of a carpenter/framer may at some point be forgiven and not pursued by the creditor. Factors commonly considered by a creditor when deciding whether to pursue a debtor include the amount of debt, the debtor's financial condition, and the legal and other costs of pursuing the debt.

IRC section 61(a)(12) provides that a debtor must recognize income in the amount of debts forgiven. IRC section 108 provides for exceptions from inclusion, stating that the amount of debt forgiven is not includable in the debtor's gross income if

1. discharge occurs in a Title 11 bankruptcy case;
2. discharge occurs when the taxpayer is insolvent;
3. the indebtedness discharged is qualified farm indebtedness; or
4. in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.

### **AUDIT TECHNIQUES:**

1. Discuss payment of liabilities during the initial interview with the taxpayer. Address both the nonpayment of taxpayer liabilities and any liabilities owed to the taxpayer which have gone uncollected. Develop as many facts as possible during the interview. Uncollectible liabilities owed to the taxpayer may be important in the consideration of a bad debts deduction. Additionally, facts may indicate the need to consider the debtor's return. An Information Report, Form 4536, may be applicable with respect to the debtor.
2. Review the liabilities account for items which have gone unpaid for extended periods. Facts relating to any liability unpaid for more than 12 months should be developed. If facts indicate that the liability is contested by the taxpayer, the accrued deduction may be premature in accordance with IRC section 461. Disputes about the quality or timing of the products or services in question, if applicable, should be developed.
3. If it is determined that the taxpayer will not satisfy a liability, economic benefit accruing to the taxpayer must be established. Such benefits are clear in the case of an accrual basis taxpayer who enjoyed the benefit of a deduction. An accrual basis taxpayer who is forgiven a debt, the amount of which was previously claimed as a deduction, should recognize income according to IRC section 61(a)12.

A taxpayer using the cash method of accounting would not have claimed a deduction since no amount was paid (provided the cash method was properly and consistently applied). IRC section



108(e)(2) prevents recognition of income to a cash basis taxpayer who had a debt forgiven because payment of the liability would give rise to a deduction.

### **Bad Debts Deduction**

A bad debts deduction is usually a questionable item and should be included in the scope of examination unless the amount is immaterial. IRC section 166(a) provides that any debt which becomes worthless within the taxable year shall be allowed as a deduction.

#### **AUDIT TECHNIQUES:**

1. Determine if the income relating to the unpaid debt was recognized. Under the cash method of accounting, a taxpayer would not be entitled to a bad debt deduction since the income related to the transaction was not recognized. Recognition of income should be verified, even for an accrual basis taxpayer.
2. Consider the taxpayer's efforts to collect the debt. The law generally allows a tradesperson to file a mechanics lien when work done for a homeowner is unpaid. Failure to file a mechanics lien may indicate that the taxpayer did not exhaust all reasonable efforts to collect the debt. For larger liabilities, and a solvent debtor, the absence of legal action by the taxpayer/creditor may indicate that all reasonable means to collect the debt have not been taken.
3. When reviewing bad debt deductions which are material in amount, the examiner should consider the potential for adjustment to the debtor's return. The use of Form 4536, Examination Information Report, should be considered.

### **UNREASONABLE COMPENSATION**

IRC section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

Section 1.162-7(b)(1) of the Federal Income Tax Regulations provides that "Any amount paid in the form of compensation, but not in fact as the purchase price of services is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock." There has been much litigation over the definition of "reasonableness," and all major tax services include an in-depth discussion of this topic.

The construction industry in general, however, is characterized by a unique business cycle which may result in more frequent occurrence of this potential tax issue. An understanding of the construction cycle is important when considering the reasonableness of salaries paid by a

corporation to its shareholders. In "good times," many builders have the opportunity to pick and choose which jobs they will accept. During these inflationary periods, profit margins sometimes increase dramatically.

Accordingly, an important consideration when evaluating the reasonableness of a salary paid in "good times," would be whether high profits are due to the shareholder's efforts or to the construction cycle.

When favorable industry conditions coincide with a dramatic increase in profits, revenue agents may encounter dramatically increased deductions for personal compensation. In evaluating the reasonableness of such deductions, agents should determine whether the increased profits are merely a byproduct of general economic conditions as opposed to superior past or present performance by the employees.

### **DIVERTING MATERIALS/LABOR FOR PERSONAL USE**

Many carpenters live in homes characterized by quality craftsmanship and fine building materials. Examiners should be alert for the potential that labor or materials entered on a return may be nondeductible expenses incurred for the personal benefit of the business owner. Some examinations have shown that a builder improperly deducted the full cost of materials and labor to build a personal residence.

The cyclical nature of the construction industry is such that participants sometimes experience slow periods in which no jobs are under way. It is during such times that a carpenter may complete work of a personal nature. A personal job may be defined as any in which, by agreement, the user of the end product does not pay the builder, or pays just a fraction of the value of the work performed. Examples include building or remodeling a primary residence or vacation home, or repair/maintenance for a parent, sibling, or other relative.

Carpenters are not precluded from completing any job for cost, of course, and this may constitute a good business practice in certain circumstances. Note, however, that in the case of work completed for a related party as defined by IRC section 267(c), an issue may be developed precluding the deduction of expenses to the extent such amount exceeds income from the same job. In such cases, the amount by which expenses exceed income may constitute a constructive gift from the carpenter to the related party.

The degree to which this potential audit issue is probed during an examination is a matter of professional judgment based on all facts and circumstances.

## AUDIT TECHNIQUES:

1. Ask the taxpayer about work completed on his/her personal residence or for a family member. The deduction of materials costs for such work may be an inadvertent oversight which the taxpayer will disclose.
2. During the initial interview, secure information to identify related parties. Ask the taxpayer about his or her family members who live in the area. It may be helpful to determine relevant maiden name(s) to identify extended family members.

**NOTE:** The examiner should be aware that the above are very personal questions which should be asked in a sensitive manner and only when deemed appropriate based on professional judgment.

3. During the interview, ask about any periods during the year in which work was slow or nonexistent. Scan the purchases journal for unusual materials or labor expenses during such periods. Develop facts to ensure that income/expense on such jobs represents an arms-length transaction.
4. When reviewing the receipts journal, be alert for any jobs completed for family members or for related entities. The net profit/loss on such jobs should be computed to determine if a potential issue exists.
5. When reviewing materials invoices, ensure that each delivery site corresponds to a job for which income is reported.
6. Identify jobs in which the costs of labor and materials exceed the related income.
7. Be alert for transactions in which the volume of materials is excessive in relation to the work performed. For example, the purchase of 500 2" x 6" x 16' for a job to build a 12' x 15' deck should be scrutinized to determine if materials were diverted to personal use (or to an unreported job). See the section in this supplement on estimating materials for more information on this topic.

If it is determined that materials for personal use were improperly deducted, examiners must fully develop all facts related to penalties, including fraud, if applicable.

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## GLOSSARY

anchor bolt	A threaded fastener embedded in the concrete used to secure another part of the building to it.
beam	One of the principal horizontal wood or steel members of the structural system.
bearing wall	A wall that supports an imposed load such as a floor or a roof of a building.
blocking	Pieces of wood to secure, join or reinforce members or to fill spaces.
board foot	A unit of measurement equal to a 1" thick piece of wood 1' square. Thickness x Length x Width equals board feet.
bridging	A brace or system of braces placed between joists to stiffen them, to hold them in place, and to help distribute the load.
built-up beam	A timber made up of several pieces fastened together, forming one of larger dimensions. See also "glue-laminated beam/timber."
ceiling joists	Planks placed horizontally, on edge, across the span between opposite walls, to which the finish ceiling material is nailed (on the bottom side) and to which the subfloor will be nailed (on the top side) if there is more than one floor. One end of each ceiling joist rests on the double plate on an outside wall. The other end rests on an interior load-bearing wall. Ceiling joists may be constructed of 2" x 6", 2" x 8", 2" x 10", and 2" x 12" material, depending on specific requirements.
column	In structures, a relatively long, slender structural compression member such as a post, a pillar or a strut; usually vertical, supporting a load, it acts in the direction of its longitudinal axis.
corner brace	A diagonal brace let into the studs to reinforce the corners of a wood-frame house.
dead load	The total weight of walls, floors, and roof bearing on the structure.

NOTE: Refer to the illustrations in Carpentry Estimating, Third Printing 1994, by W.P. Jackson, Craftsman Book Company for illustrations of framing components and a schematic diagram of a home.

end joists	Horizontal planks at either end of the floor frame running in the same direction as the floor joists.
floor joists	Horizontal planks placed on edge on which the subfloor will be nailed.
gable	The vertical section under the sloped part of a roof.
glue-laminated beam/timbermore	A manufactured product consisting of four or wood layers bonded together with adhesive.
head, header	Double wood pieces supporting joists in a floor or double wood members placed on edge over windows and doors to transfer the roof and floor weight to the studs.
header joists	Pieces of lumber the same size as the floor joists. They are nailed to the ends of the floor joists in a continuous band to prevent the floor joists from tipping or rolling.
joist hanger	A metal strap or angle used to fix a joist to a girder or beam.
joists	Small rectangular sectional members arranged parallel from wall to wall in a building, or resting on beams or girders. Their function is to support the floor above or the ceiling below.
linear foot	A measure of lumber based on the actual length of the piece.
on-center spacing	Also referred to as "O.C.," the on-center spacing is the distance from the center of one supporting member to the center of the next, usually 12", 16", or 24". The greater the anticipated load or the longer the span, the closer the spacing. The most common spacing for ceiling joists is 16" O.C.
pitch	The angle of the slope of the roof, usually expressed as a ratio of vertical rise to horizontal run.
rafter	One of a series of parallel structural roof members spanning from an exterior wall to a center ridge beam or ridge board.

NOTE: Refer to the illustrations in Carpentry Estimating, Third Printing 1994, by W.P. Jackson, Craftsman Book Company for illustrations of framing components and a schematic diagram of a home.

ridge beam	A thick longitudinal plank to which the upper ends of the board rafters are attached for support and stability.
sheathing	A covering (usually boards, plywood, or wall boards) placed over the exterior studding or rafters of a building; provides a base for the application of wall or roof cladding.
sill, sill plate	A horizontal timber, at the bottom of the soleplate frame of a wood structure, which rests on the foundation.
spacer block	A 2" x 6" or 2" x 8" block installed between offset ceiling joists or at the end of a strongback over an outside wall or interior partition wall. The spacer for a strongback is the same height as the width of the ceiling joists.
subfloor	A structure of boards or panels which is fastened to the floor frame. It provides a base for the underlayment and finished floor materials. (Underlayment is material placed over the subfloor to provide a smooth, even surface for the carpet or other finished floor material. It may be thin plywood or unveneered panels.) The subfloor is the first application of material to the floor frame.
top plate	The horizontal member at the top of the wall studs; on the top floor, the lower ends of the rafters are attached to it.
truss	A combination of structural members usually arranged in triangular units to form a rigid framework for spanning between load-bearing walls.

NOTE: Refer to the illustrations in Carpentry Estimating, Third Printing 1994, by W.P. Jackson, Craftsman Book Company for illustrations of framing components and a schematic diagram of a home.

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## APPENDIX A

### SUMMARY OF STATE LICENSING/REGISTRATION REQUIREMENTS

<u>State</u>	<u>Address</u>	<u>License/registration requirements</u>
Alabama	Alabama Licensing Board for General Contractors 400 South Union St., Suite 235 Montgomery, AL 36130 (205) 242-2839	License is required for public and private projects costing \$20,000 or more and swimming pool projects costing \$5,000 or more.
Alaska	State of Alaska Department of Commerce and Economic Development Juneau, AK	Registration required only.
Arizona	State of Arizona Registrar of Contractors 800 West Washington St. Phoenix, AZ 85007 (602) 542-1525	License is required for all contractors submitting bids or performing work.
Arkansas	State of Arkansas Contractors Licensing Board 621 E. Capitol Ave. Little Rock, AR 72202 (501) 372-4661	License is required for public and private projects costing \$20,000 or more.
California	State of California Registrar of Contractors Contractors State License Board 9835 Goethe Rd. Sacramento, CA 95826 (916) 255-3900	License is required for public and private projects costing \$300 or more.

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Colorado		License or registration is not required.
Connecticut	Connecticut Department of Consumer Protection 165 Capital Ave. Hartford, CT 06106 (203) 566-3275	License is required for specific technical work. A registration is required for "home improvement" work.
Delaware	Delaware Division of Revenue 820 North French St. Wilmington, DE 19801 (302) 577-3300	License is required for all contractors.
District of Columbia	D.C. Office of Consumer and Regulatory Affairs Washington, DC (202) 727-7100	Only home improvement contractors must be licensed.
Florida	Florida Construction Industry Licensing Board Richard P. Daniel State Office Building, P.O. Box 2 Jacksonville, FL 32201 (904) 359-6310	License is required for all contractors.
Georgia		License or registration is not required.
Hawaii	Hawaii Department of Commerce and Consumer Affairs Professional and Vocational Licensing Division 1010 Richard St. Honolulu, HI 96801 (808) 586-3000	License is required for all except federal projects.

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Idaho	Idaho Public Works Contractors State License Board 1109 Main St. P.O. Box 83720 Boise, ID 83720-0073 (208) 334-2966	License is required for public works projects over \$5,000.
Illinois		License or registration is not required.
Indiana		License or registration is not required.
Iowa	Labor Commissioner	Registration is required for all projects unless the contractor earns less than \$1,000 annually.
Kansas		Registration may be required to ensure the payment of taxes.
Louisiana	Louisiana State Licensing Board for Contractors 7434 Perkins Rd. Baton Rouge, LA 70808 (504) 765-2301	License is required for most public and private projects over \$50,000.
Maine		License or registration is not required.
Maryland	Maryland Comptroller of the Treasury State License Bureau 301 W. Preston St., Room 404 Baltimore, MD 21201 (410) 225-1550	License is required for all contractors.
Massachusetts		License or registration is not required.

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Michigan	Michigan Department of Licensing and Regulation P.O. Box 30018 Lansing, MI 48909 (517) 373-0678	License is required for residential building projects.
Minnesota		License is required for residential work only.
Mississippi	Mississippi State Board of Public Contractors 2001 Airport Rd., Suite 101 Jackson, MS 39208 (601) 354-6161	License or certificate is required for public projects over \$50,000 and private projects over \$100,000.
Missouri		License or registration is not required.
Montana	Montana Department of Commerce Public Contractor's Department 1218 East South Ave. Helena, MT 59620-0401 (406) 444-4390	License is required for public works projects over \$5,000.
Nebraska		License or registration is not required.
Nevada	Nevada State Contractors Board 70 Linden St. Reno, NV 89502 (702) 688-1141	License is required for all public and private projects.
New Hampshire		License is required for electricians and plumbers only.
New Jersey		License is required for plumbers, electricians, and home repair contractors.

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New Mexico	State of New Mexico Construction Industries Div. 725 St. Michaels Dr. P.O. Box 25101 Santa Fe, NM 87504-9990 (505) 827-7030	License is required for public and private projects except for federal projects.
New York		License or registration is not required.
North Carolina	Mark D. Selph Secretary-Treasurer North Carolina Licensing Board for Contractors P.O. Box 17187 Raleigh, NC 27612 (919) 571-4183	License is required for any projects financed with only state funds of \$30,000 or more.
North Dakota	Secretary of State	License is required when the cost or value of the contract is over \$500.
Ohio		License or registration is not required.
Oklahoma		License or registration is not required.
Oregon	Oregon Construction Contractors Board (503) 378-4621	License is required for residential, commercial, and public works projects.
Pennsylvania		License or registration is not required.
Puerto Rico		License or registration is not required.

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Rhode Island	Builders Registration Board	A certificate of registration is required for residential construction over \$5,000.
South Carolina	State of South Carolina Contractors Licensing Board P.O. Box 11329 3600 Forest Dr., Suite 100 Columbia, SC 29211 (803) 734-4255	License is required for projects over \$30,000.
South Dakota	Department of Revenue Excise Tax Division 700 N. Illinois Pierre, SD 57501	A Contractor's Excise Tax License is required for persons engaged in making real estate improvements.
Tennessee	Tennessee State Board for Licensing Contractors 500 James Robertson Parkway Suite 110 Nashville, TN 37219 (615) 741-2122	License is required for public or private projects over \$25,000.
Texas		License or registration is not required.
Utah	State Department of Commerce (801) 530-6628	License is required for public and private projects.
Vermont		License is required for electricians and plumbers only.
Virginia	Virginia Department of Commerce State Board for Contractors 3600 West Broad St. Richmond, VA 23230 (804) 367-8511	License is required for all contractors.

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Washington	State of Washington Dept. of Labor and Industries Div. of Building and Construction Safety Inspection Services Contractor Registration Section 7273 Lindersen St. Tumwater, WA 98502 (206) 956-5226	Certificate of Registration is required to do any work as a contractor.
West Virginia	West Virginia Contractor 319 Building 3 Capitol Complex Charleston, WV 25305 (304) 558-7890	License is required for all contractors.
Wisconsin		License or registration is not required.
Wyoming		License is required for electrical contractors only.

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## **APPENDIX B**

### **REFERENCE MATERIALS**

*National Construction Estimator*, 43rd Edition, by Martin D. Kiley, Craftsman Book Company.

*Means Repair and Remodeling Cost Data 1995*. Copyright R.S. Means Co., Inc., Kingston, MA 617-585-7880.

*Carpentry Estimating*, Third Printing 1994, by W.P. Jackson, Craftsman Book Company.