

Market Segment Specialization Program



Trucking Industry

The taxpayer names and addresses shown in this publication are hypothetical. They were chosen at random from a list of names of American colleges and universities as shown in Webster's Dictionary or from a list of names of counties in the United States as listed in the United States Government Printing Office Style Manual.

This material was designed specifically for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position.



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Chapter 1

INTRODUCTION

PURPOSE AND NATURE OF THE INFORMATION IN THIS REPORT

The purpose of this Guide is:

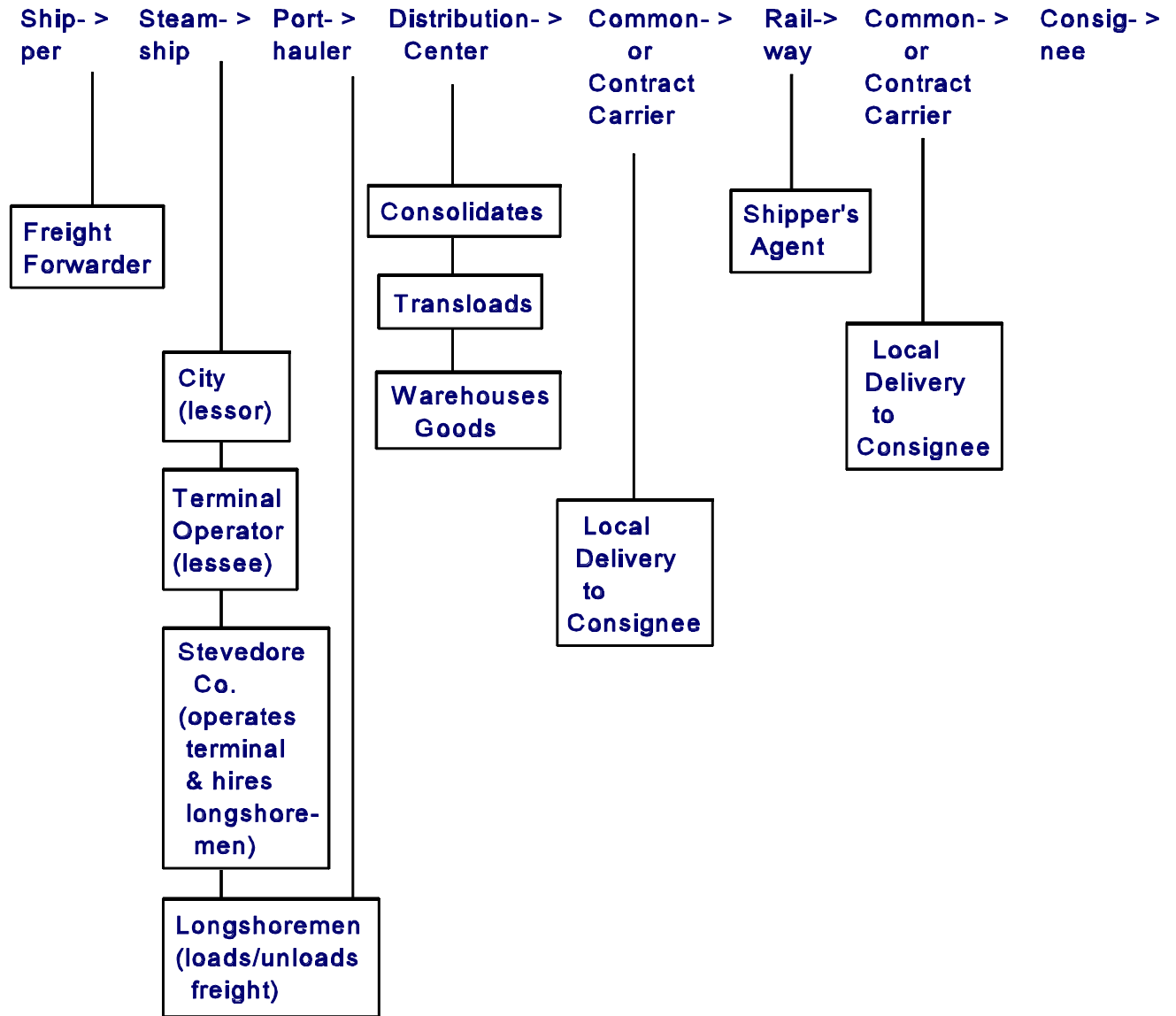
1. To provide an overview of the trucking industry.
2. To familiarize agents with issues and terminology found in the industry.
3. To assist agents with their examinations by providing audit techniques.

Reviewing the information provided in this Guide should help agents reduce the time needed to examine returns in the trucking industry and its related areas by providing some familiarity with the industry prior to commencing the examination. While the information presented in this Guide sets forth a general overview of the industry, it is not all-inclusive.

SCOPE OF THE INDUSTRY AUDITED

What is the trucking industry? It's much more than just the common carrier vehicles transporting goods from one location to another. The trucking industry extends to include freight forwarders, shipper's agents, consolidators, break-bulk agents, custom house brokers, distributors and warehousemen. Many companies will combine the above functions in offering a full service operation to their customer. Below is an illustration of the various parties to a transaction:

Illustration of the Related Transportation Industries



Trucking companies are classified as:

1. **Private carriers** - Businesses that own and operate trucks in transporting their own goods; for example a chain of supermarkets would truck food from its warehouses to its own stores.
2. **For-hire carriers** - Common carriers that earn profits by transporting freight for other businesses or individuals. For-hire carriers operate in local areas. The United States has about 36,000 for-hire trucking firms. For-hire carriers are further classified as:
 - a. **Common carrier** is a person or company that transports, for a fee, passengers and goods by water, land, or air. Such carriers set rates, haul specific types of freight, and operate only on certain routes. The common carrier is liable for loss or injury to goods or passengers.
 - b. **Contract carriers** are common carriers that charge rates which are set by contract with the shipper. This allows them to discount their rates for volume shipments.
 - c. **Exempt carriers** transport only special kinds of goods or use their trucks only for specific purposes. Exempt carriers will haul certain agricultural products or carry newspapers.

CORPORATE ISSUES

The following is a compilation of the issues encountered during the audits of general freight carriers:

1. Employment tax issues:
 - a. Conversion of independent contractors to employee status.
 - b. Supplemental wages for bonuses, pensions, or vacation pay not included as wages.
 - c. Cash payments to lumpers or swampers (cargo handlers) were classified as outside services but should be wages.
2. Excise tax issues:

- a. Heavy Vehicle Use Tax - Form 2290.
- b. Retail sales tax (glider kits) - Form 720.
3. Unreported sales of fixed assets.
4. Additional income from customer credit balances, overpaid accounts, or unapplied cash receipts.
5. Capitalization of repairs or additional equipment (such as, radios and computers).
6. Depreciation of assets no longer owned by the corporation.
7. Basis of assets improperly calculated.
 - a. Transfers between related parties not recorded at adjusted basis.
 - b. Financing charges included in adjusted basis.
 - c. Trade-in allowance not being taken into account.
8. Misclassification of meals and entertainment to avoid the 20 percent limitation as well as the deduction of numerous personal expenses.
9. Penalties (traffic violations or customs duties).
10. Leasing of equipment from shareholders not at fair market value (disguised dividends, generation of passive losses, or passive gains).
11. Self-insurance policies and reserves.
12. Kickbacks - cash payments to corporate officers/employees for the release of earnings.

Chapter 2

GENERAL BACKGROUND INFORMATION

GENERAL

The least expensive way to move general cargo is by water. However, most of the transportation within the United States is done by rail and trucks. Rail transportation costs about three times as much as water transportation. Truck transportation is about 10 times more than by water, and air transportation about 40 times more than by water. Cargo planes usually carry only expensive, lightweight, or perishable merchandise.

The United States has approximately 40 million trucks and spends about \$110 billion yearly to transport goods by truck. The trucking industry hauls about 75 percent of the nation's industrial products and employs over 7 million people.

GOVERNMENT REGULATION

Airline, railroad, and trucking industries are among the most heavily regulated industries in the United States. The Federal Government began regulating transportation companies in the late 1800's to prevent railroads from charging unfair freight rates. Regulation also helped to protect transportation companies from unfair competition.

In 1935, Congress passed the Motor Carrier Act. This gave the Interstate Commerce Commission (ICC) authority to regulate the motor carriers and drivers involved in interstate commerce by granting operating permits, approving trucking routes, and setting tariff rates.

The ICC set uniform tariff rates for hauling freight. Thus, the trucking companies had to charge small shippers the same tariff rate as large shippers. This prohibited large shippers from receiving volume discounts and an unfair trade advantage due to lower freight costs. Since the rates were uniform for all trucking companies, there was little or no competition due to pricing.

To reduce shipping costs, reduce handling of the freight, and cut losses due to damage or theft, containerization became a popular method of transporting freight during

the mid-1900's. This consists of packing freight into big crates called containers. The containers could then be transferred between container ships, truck trailers, and railroad flatcars. Trucking is often used in combination with the railroad in a method called "piggybacking." This occurs when the trailer chassis (with the loaded, sealed container attached) is separated from the tractor and loaded directly onto a railroad flatcar. When the trailer arrives at its destination by railroad, it is reconnected to another tractor for transport to its final destination.

EFFECT OF DEREGULATION

The Motor Carrier Act of 1980 partly deregulated the trucking industry by making it easier to obtain permits and by easing restrictions on the operation of various types of carriers. Trucking companies could now discount the standard tariff rate, but must file the discounted rates with the ICC.

Prior to deregulation, the trucking industry was heavily unionized. Since trucking companies would file for new tariffs whenever the unions negotiated higher wages, both union members and trucking companies would prosper. With deregulation, price competition increased, which resulted in lower profit margins and forced many companies out of business. It became increasingly difficult for the trucking companies to operate with union drivers. Since union drivers receive additional benefits through provisions in the union contracts for medical coverage and funding of the union pension plan, their compensation is usually 35 percent more than non-union drivers. To reduce operating costs, new corporations would be formed to operate with non-union drivers or independent contractors.

As of today, the Government's role in the transportation industry consists primarily of (1) providing funding for certain transportation facilities and (2) regulating certain aspects of transportation, such as safety. The Surface Transportation Act of 1982 which sets uniform size and weight limits for the trucking industry nationwide is an example of this. Under this law, trucks that use interstate highways may not weigh in excess of 80,000 lbs.

FEDERAL AGENCIES

There are four Federal agencies that are involved in the regulation of trucking companies. Each is briefly discussed.

Interstate Commerce Commission (ICC)

The ICC oversees the railroad and interstate trucking. Interstate trucking involves the movement of freight across state lines. The classification of the shipment (interstate vs. intrastate) is based on the intent of the shipper as to the routing of and the final destination of the shipment.

Airfreight shipments as well as container freight shipments which enter the state through one of the harbor ports are considered to be interstate commerce. Airfreight shipments are usually handled by a freight forwarder and are regulated by the International Airline Transportation Agency (IATA).

Under Title 49 of the Code of Federal Regulations which govern transportation, the ICC is responsible for issuing operating permits and regulating interstate freight rates. It approves the carrier's rates and routes, types of commodities transported, finances, accounting practices, and mergers and acquisitions.

U.S. Customs

U.S. Customs is the Federal agency which oversees the entry of foreign goods into the United States. They operate under Title 19 of the Code of Federal Regulations. They issue customs house licenses which allows a third party to act as an agent for the importer (consignee) in processing the paperwork and payment of customs duties before the goods are released for their final destination.

Department of Transportation (DOT)

DOT is responsible for distributing the Federal funding for transportation. About \$18 billion is collected annually in highway use taxes by Federal and state governments which is used for the construction and repair of roads. Agencies within the DOT set and enforce the Motor Carrier Safety Regulations (MCSR) which sets safety standards for the design and manufacture of transportation equipment. The DOT regulates the operations of private carriers (such as, specifies the number of hours a driver can work without rest; the interstate transport of chemicals and other

hazardous cargoes). The DOT requires a record be kept on the inspection and repair history of equipment used in the transportation of hazardous materials.

Federal Maritime Commission (FMC)

FMC regulates the overseas shipping industry. They are responsible for issuing licenses for non-vessel operating common carriers and regulating the tariffs charged for ocean freight shipments.

STATE AGENCIES

There are two state agencies that have regulatory authority over the trucking industry in each state.

Public Utilities Commission (PUC)

The Tariff and License branch in the transportation division of the PUC regulates intrastate trucking. Intrastate trucking refers to freight shipments commencing and concluding within the state. The PUC issues operating permits and sets minimum and maximum intrastate freight rates. The PUC requires trucking firms, depending on the size of the annual gross receipts, to file quarterly and/or annual reports.

Department of Motor Vehicles (DMV)

The DMV requires the registration of vehicles and licensing of drivers. To register or renew the registration on a tractor, the owner has to show proof of payment for the Heavy Vehicle Use Tax, Form 2290. A schedule of equipment registered to the company or subhauler is required to be filed with the Form 2290.

EFFECT OF GOVERNMENT REGULATION ON AUDIT

Government agencies (other than the IRS) are mostly concerned with:

1. Safety violations.
2. Price floors.
3. Weight classes and rates.

For the most part, the Government agencies are interested in monitoring items which are of little use in an audit of a tax return. They are mainly interested in the following areas:

	<u>ICC</u>	<u>DOT</u>	<u>PUC</u>
1. Freight Rates	X		X
2. Issuance of operating permits	X		X
3. Authority to establish routes and types of commodities	X		X
4. Provides guidelines on financial and accounting practices	X		X
5. Provides safety and hazardous materials guidelines		X	

Although the authority of some of these regulatory agencies has been diminished due to deregulation of the industry, their presence is still effective in setting standards for the industry to follow.

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Chapter 3

PLANNING THE AUDIT

INTRODUCTION

Planning of the examination consists of:

1. Preauditing the tax return by identifying potential issues and preliminary research of issues, such as:
 - a. Converting independent contractors to employees (20 common law factors).
 - b. Forms 1099 not issued or issued incorrectly (back-up withholding penalties).
 - c. Excise taxes (heavy vehicle use tax, retail sales tax).
2. Preparing and issuing the initial Information Document Request (IDR), Form 4564.
 - a. Items requested prior to initial appointment.
 - b. Items to be available at the initial appointment.
 - c. Determining the site of the examination.
3. Contacting the taxpayer by mail or by telephone to schedule the initial appointment. Telephone contact should be followed-up with a letter to confirm the scheduled appointment.
4. Preparing the initial interview questions.

PRE-AUDIT PLANNING

To prepare for the audit, agents should try to familiarize themselves with the terminology and the transactions normal for the industry. See the Glossary for terminology and abbreviations. For specific items, refer to comments under each transportation category.

The following Internal Revenue Manual sections provide audit guidelines for the trucking industry and independent contractors:

Reference Material

IRM 4235-815	Trucking Industry
IRM 4231-6(18)0	Truckers
IRM 4232.6	Railroads

The second page of the corporate return indicates what type of business activity the taxpayer is engaged in. With a trucking company, the entire return should be reviewed to determine what segment of the industry the taxpayer is involved in. Keys to identifying the business activities are:

<u>Expenses claimed On Return</u>	<u>Common Carrier</u>	<u>Shipper's Agent</u>	<u>Freight Forwarder</u>
1. Subhauler fees	X		
2. Commissions		X	X
3. Gains on sale of assets	X		
4. Foreign currency gains or losses			X
5. Fixed asset schedule (tractors, trailers)	X		
6. Fixed asset schedule (office equipment only)		X	X
7. Outside services (payments to lumpers, swampers)	X		
8. Factoring fee	X		

An expense for subhaulers on the return listed under cost of goods sold or other deductions, is an indication the company is involved with the actual hauling or the delivery of freight. If this is the case, request a PATRA, Privacy Act Transcript of Account. Although at this time, the PATRA does not list to whom a Form 1099 was issued or filed, it will indicate the type, number, and the total dollar amount of the information returns filed. This transcript should be reconciled to the Form 1096 and Forms 1099 provided by the taxpayer.

Prior to the initial appointment, copies of the prior and subsequent income tax returns, and the working trial balance should be requested.

By requesting this beforehand, the reconciliation and comparative analysis of the balance sheet and the profit and loss statement can be performed. This will enable the agent to become familiar with the accounts on the tax return and may direct the agent to specific areas of audit concern.

Other information which is available prior to meeting with the taxpayer are:

1. Articles of Incorporation (through LEXIS).
2. DMV information (by telephone).
3. PUC license (by telephone).
4. ICC license (by telephone).

RELATED PARTY TRANSACTIONS

In general, any time there are business transactions between related parties, special attention should be paid to determining if the transactions are conducted at arms length (that is, shifting income and expense from one entity to another).

The agent should attempt to determine all of the related parties during the preaudit analysis so the required returns can be requested on the initial IDR. Questioning the shareholder(s) during the initial interview and inspection of the individual tax return(s) could reveal related partnership and corporate returns.

Many of the trucking companies audited had one or more of the following related entities:

1. Brother-sister corporations.
2. Subsidiaries.
3. Schedule C business on the shareholder's individual tax return.
4. Partnerships.

Example 1

In one audit, a sole shareholder owned three corporations, and used three different CPAs to prepare the tax returns. None of the CPAs were aware of the existence of the other corporations.

Many trucking companies set up separate business entities to handle various aspects of the business. Most of the related party transactions involved the rental of equipment and buildings from the shareholder or other related entity. Other types of related party transactions encountered were:

1. Repairs and maintenance handled by the shareholder.
2. Employee leasing from a related corporation or partnership.
3. Separation of business segments by creation of subsidiaries (brother-sister corporations).
4. Loans to or from shareholders.

The following explanations have been given for utilizing separate businesses:

1. To limit the liability to the trucking company. If they should get sued for any reason in the course of hauling freight, the assets would be protected in a separate entity.
2. Companies involved in interstate trucking were required by the ICC to keep the various business operations in separate entities.
3. Due to the Motor Carrier Act of 1980 which deregulated the trucking industry, companies became concerned with their cost effectiveness. They found it was more cost effective to use non-union drivers. Thus, new non-union companies would be formed while the old company would become dormant.
4. Shift business operations from one corporation to another to keep workman's compensation rates low and to avoid funding the pension fund.

Transactions which involve rental activities, should be examined with the following issues in mind:

1. Whether the fair rental value of the equipment or real property is excessive (disguised dividends). This can be verified by contacting a third party (such as, equipment leasing co., real estate co.) or the services of an engineer can be requested by submitting Form 5202.
2. Whether the rental activity qualifies as a passive activity per IRC section 469(c)(2) and the income generated is passive income (PIGS) and is being offset against other passive losses, or are passive losses being generated to offset other passive gains.

3. Whether the shareholder materially participates in the operations of the activity per IRC section 469(h) to offset losses against ordinary income.

INFORMATION DOCUMENT REQUESTS

The following items should be requested for a trucking company:

1. Tax returns for related parties (corporations, partnerships, shareholders).
2. Organizational flowchart showing the structure of the business, shareholder involvement and ownership percentages.
3. Forms 8300 filed.
4. Quarterly and annual PUC reports and audit reports from PUC and ICC.
5. Excise tax returns:
 - a. Form 2290 - Heavy Vehicle Use Tax.
 - b. Form 720 - Retail Sales Tax.
6. Copies of all Forms 1099 and the transmittal Form 1096.
7. Copies of Forms W-9 secured for independent contractors and outside laborers.
8. Driver manifests and trip settlement sheets used to prepare the Form 1099.
9. Copies of Forms W-2 or year-end computer schedules showing all employees for the year.
10. Detailed depreciation schedule of tractors and trailers.
11. Pink slips or DMV registrations for the vehicles owned and registered by the company.

INITIAL INTERVIEW

The initial interview can provide a variety of information. The following items are some recommendations of things to consider during the initial interview.

Site of the Examination

The site of the examination should be at the place of business. Most trucking companies have computerized books and records and each segment of a transportation move is supported by invoices and bills of lading. Due to the extensive amounts of paper generated from these transactions, most of the taxpayers examined have accommodated the request to work at the place of business.

If the site of the examination is not at the place of business, the agent should request a tour of the business premises at the time of the initial interview or at some point during the initial phase of the audit.

Tour of the Business Premises

The tour of the business premises can provide an agent with a picture of the business entity, the magnitude of its operations, and identify areas of audit concern not evident on the tax return. In addition to a tour of the business, the initial interview should include questions regarding the operations of the company (see Related Party Transactions), a walk-through of the books, records, and accounting transactions, a discussion of the auditing procedures to be applied, and an estimated timetable for the completion of the audit.

The discussion should also include an explanation of how the IDR's will be issued, the turnaround time for fulfilling the request, and to whom the request should be submitted. If the IDRs are to be submitted to someone other than the officer/shareholder or the power of attorney, it is suggested that the agent obtain a letter on company letterhead and signed by the officer/shareholder, designating the person to receive the requests.

Initial Interview Questions

1. General questions:
 - a. What type of services are offered to the customer?
 - 1) Cartage.
 - 2) Consolidation.
 - 3) Warehousing.
 - 4) Freight Forwarders.
 - 5) Shippers Agent.
 - 6) Customhouse Broker.
 - 7) Non-Vessel Operating Common Carrier.
 - 8) Break-bulk Agent.
 - b. What type of hauling is done? (such as, local pickup and delivery, long distance hauling, porthauling, interstate, intrastate).
2. Advertising or sales expenses:
 - a. Who are your major customers?
 - b. How are your customers obtained?
 - c. Are contracts entered into?
3. Sales:
 - a. Were there any sales of equipment during the tax year under audit?
 - b. Was there any income from leasing equipment? This is another source of revenue for some trucking companies. If the company has numerous tractors and trailers on the depreciation schedule then their drivers are probably "employees."
 - c. What happens to unclaimed or damaged goods?
 - d. Does the company factor any receivable accounts?

4. Employment Tax:

- a. Who owns the transportation equipment (for example, tractors, trailers)?
- b. How many terminals are there?
- c. Where are the terminals located?
- d. Are there pre-determined routes or service areas?
- e. If there are independent contractors (subhaulers) involved, determine whether they should be employees by going over the 20 common law factors with the taxpayer during the initial interview.

5. Excise Tax:

- a. What type of freight does the company transport? (such as, LTL, TL, average weight of loads).
- b. Does the company have fuel pumps on the premises?

6. Other Compliance Areas:

- a. Were Forms 8300 filed?
- b. Is the taxpayer aware of the filing requirements?
- c. Are there any foreign currency transactions?

Chapter 4

OPERATIONS AND ACCOUNTING RECORDS

COMMON CARRIERS

The highway common carrier engages in the transportation of freight over the highways. A common carrier must obtain operating authority from the ICC or PUC and file a copy of their tariff rates with each agency.

A common carrier may be referred to as the prime carrier. A prime carrier is the principal or overlying common carrier. The prime carrier enters into a contract with a shipper to provide transportation services, but in turn, engages the services of another authorized common carrier or independent contractor (subhauler) to perform the transportation service.

Operating Authority

1. **PUC** - Highway common carriers operating within the boundaries of one state (intrastate trucking) are required to have PUC operating authority or a trip permit (bingo stamps) to carry freight within the state. The registered owner must also file proof of insurance (certificate of insurance) with the PUC.
2. **ICC** - An ICC operating license or permit is required if freight is transported more than 20 miles from the harbor or between states. Companies carrying both intrastate and interstate freight, must have permits from both agencies. An owner/operator can use the prime carrier's ICC authority if the equipment is leased to the prime carrier.

Tariffs

A highway common carrier or contract carrier is required to file their tariff rates or contract rate schedule with the PUC and the ICC. These rates are dependent upon the classification of goods, type of load, weight, and distance the freight is to be hauled. Common tariff rate publications are:

1. Distance Table 8 issued by the PUC.
2. Hazardous Material Tariff.

3. National Motor Freight Classification.
4. Rocky Mountain Tariff.

CONTRACT CARRIERS

A contract carrier enters into a bilateral agreement with the shipper or consignee for transportation services. The contract defines the services to be provided, the commodities transported, the projected tonnage and the rates charged. Contracts are to contain a specific termination date, not exceeding one year. The contract can be renewed by amendment. The contract carrier can offer freight rates which are lower than a common carrier's published tariff since the rate will be based on the projected tonnage of freight for the year.

Accounting Records

Common carriers and contract carriers maintained a formal, double entry set of books which were computerized and prepared by the in-house staff. Typically, the bookkeeping was very complete, with many supporting journals and ledgers. A CPA would prepare the working trial balance, adjusting journal entries, financial statements, and the income tax returns. Supporting documentation for accounting entries consists of:

1. Freight (sales) invoices.
2. Tariff rate publications.
3. Rate contracts (contract carriers).
4. Bills of lading.
5. Delivery receipts.
6. Driver's manifests.
7. Receipts (vendor invoices) for expenses.

Since many companies hire subhaulers to perform the actual transportation task, they keep administrative and accounting records on the subhauler consisting of some, if not all of the following items:

1. Subhaul agreement including equipment schedule.
2. Copy of driver's license.
3. Copy of vehicle registration.
4. Medical examination.
5. Drug testing certificate.
6. Driver's examination.
7. Customs house license application on file with U.S. Customs.
8. Copy of social security card.
9. Certificate of insurance.
10. W-9

Accounting or Transactional Cycle

The company generates an invoice based on the following transactions:

1. The process begins when the trucking company receives a call from a shipper requesting that freight be picked up and delivered. The trucking company will take all of the pertinent information, such as the type of freight and the place of delivery, and calculate a tentative price for the haul.
2. The information is transferred onto a prenumbered document referred to as the "pre-note." This is used to input the customer's haul into the computer system. The information is also given to the dispatcher to arrange the pick up and delivery of the freight.
3. The rate clerk will then rate the freight move and input the information into the computer to prepare the freight bill or sales invoice. The invoice is usually prepared in six parts and distributed as follows:
 - a. 2 copies to the customer - customer keeps one copy and remits one with the payment.
 - b. 1 copy is filed numerically with a copy of the bill of lading attached.

- c. 1 copy is filed alphabetically by customer.
 - d. 1 copy goes with the driver and is signed by the consignee upon acceptance of the shipment as proof of delivery (delivery receipt).
 - e. 1 copy goes with the shipment and bill of lading to the consignee (packing list).
4. The driver is given a copy of the driver's manifest which specifies where to go and the amount and kind of freight to be picked up.
 5. When the driver arrives at the shippers location, the driver is presented with a bill of lading, which is a detailed list of all freight to be hauled.

The bill of lading indicates which party is to be billed for the freight charges. If the bill of lading for the shipment is marked "PREPAID" or "FOB" (free on board), then the shipper will be invoiced for the freight charges.

If the bill of lading is "COLLECT," then the consignee will be invoiced for the freight charges.

6. The driver compares the freight to the bill of lading to make sure there are no discrepancies. If there are no discrepancies, the driver will sign the bill of lading and retain a copy for the trucking company's records.
7. When the driver delivers the goods to the consignee, the consignee will inspect the shipment and compare it to the bill of lading. The consignee will sign a delivery receipt, accepting the delivery and a copy will be retained for the trucking company's records.
8. When the driver returns to the terminal, the bill of lading and the delivery receipt will be given to the accounting department. The bill of lading and the delivery receipt will be associated with the pre-note. The driver will also turn in the driver's manifest or trip settlement sheet.
9. The driver's manifest is then used to calculate the earnings of the subhauler.

Sources of Revenue

Income is generated by the movement and handling of freight. Each freight move generates an invoice and should be accompanied by a bill of lading and a delivery receipt. Under ICC regulations, billings must be completed within 15 days and payment made within 7 days of receipt of the billing. Income is categorized in the following accounts:

Transportation/Cartage

This item will make up the vast majority of the income on a trucking return. Transportation or cartage fees are determined by tariff rates or contracts with the shipper. Truck load (TL) shipments are usually a flat rate for the trailer based on the origination and destination points. Less than truck load (LTL) shipments are billed at higher rates based on the origination and destination ZIP Codes and the class and weight of the goods.

Brokerage Fees

Brokered transportation income is the contract rate paid by the shipper for the transportation of goods. The brokered transportation expense is the amount paid to the contract or common carrier for the actual transportation. The difference between the two represents the profit margin to the company.

"COD" Fees

Sometimes, due to the non-payment of goods, or the non-payment of freight charges, a shipment will be made COD (cash on delivery). If the shipment is COD, the consignee will need to pay for the goods at the time of delivery. Thus, the driver picks up a check from the consignee made payable to the shipper and a separate check made payable to the trucking company for the collection fee. The check may be made payable to the trucking company for the amount of the goods and the collection fee. The transportation company will keep the fee and forward a check to the shipper for payment of the goods.

Cargo Handling

Cargo handling is the fee charged for transloading and consolidation of shipments. An example of this is, picking up three 40-foot containers and repacking the contents to fit into two 48-foot trailers for shipment to the rail yard. It can also include the repacking

and mixing of goods (for example, adding labels or mixing cartons of merchandise). The freight forwarder or break-bulk agent will offer these services.

Warehousing/Storage

The warehousing operation is usually a function of a freight forwarder, but it can be the major business function of the company with the trucking operation an ancillary to that function. The warehouse may be the distribution center for a retailer of goods.

During the tour of the business the agent should be aware of the size of the facilities and look for goods (boxes and crates) which appear to be stored on the premises. If the company does not have warehousing or storage income on the return, they may have neglected to report it. Warehousing income is negotiated and calculated at cents-per-carton or cents-per-cubic foot for the number of days the merchandise is held.

A successful warehousing operation requires building facilities in excess of 30,000 square feet. Depending on the customer's goods and shipment needs, larger facilities may be necessary. Expenses which are more significant in a warehousing operation include security, pallets, and repairs and maintenance of forklifts.

The freight invoice will specify any additional charges (such as forklift use by the customer at their facility and demurrage or detention fees incurred on behalf of the shipper). These are usually under the category of "other income," instead of offset against the expenses incurred.

Unreported Income

In determining whether sales have been properly reported, a sample of the freight bills recorded during the first 5 days of the subsequent year should be traced to a copy of the bill of lading and the delivery receipt to determine the date of delivery and the accounting period the income should have been reported.

Agents should scan the cash receipts journal for any unusual items such as undisclosed sales of equipment, workman's compensation dividends, and payoffs on insurance claims for damaged cargo or equipment.

Factored Accounts Receivable

In many instances, a trucking company will utilize the services of a factoring company. The factoring company acts as a financial institution by providing cash for operations and as a collection agency for the accounts receivable. Some or all of the accounts receivable may be factored. As previously stated, a trucking company is required to pay its subhaulers within 7 days of receipt of services. To increase cash flow to meet these expenses, the accounts receivable will be factored. Problems arising from the factoring of accounts receivable are:

1. Cash basis taxpayers may fail to include income from factored A/R. Cash received may be diverted to the shareholder's personal accounts.
2. Accrual basis taxpayers may fail to include income from factored A/R, by excluding those invoices from sales. The monthly factoring statements should be reviewed to verify factored invoices have been accrued as sales.

Refunds of Workmen's Compensation

Most insurance companies will refund workman's compensation premiums in April if the actual claims filed are less than the pre-determined experience rates used in the prior year. If actual claims exceed the pre-determined experience rates, then the insurance company bills the company to cover actual claims and adjust the experience rate in the new policy.

Reimbursement of Insurance Claims

Although most companies choose not to file a claim for damaged cargo or for equipment damages due to the high deductibles, a test or review of the bank deposits can reveal reimbursements for insurance claims.

Sales of Fixed Assets

Most trucking companies own tractors, trailers, yardgoats, and forklifts. As the equipment ages, the tractors and trailers require more costly repairs and maintenance. To avoid this, the trucking company will acquire new equipment and dispose of the old equipment by selling it to a third party or trading it in. The tax return should reflect the sale of equipment as an IRC section 1231 gain or loss or a reduction in the basis of the new equipment. Some suggested audit techniques are:

1. Obtain the fixed asset schedule and depreciation schedules prepared by the taxpayer and/or CPA. These schedules should list the internal unit number given to each piece of equipment. This unit number is often used to identify the equipment for various other documents, such as volume tickets, sales invoices, repair bills, etc. If these schedules have been lost or destroyed, the fixed asset schedule can be reconstructed by:
 - a. Contacting the DMV for current information on the transportation equipment registered to the company and its shareholders. The initial interview should include questions regarding any equipment sales during the tax year under examination.
 - b. Reviewing the PUC annual report and schedule of equipment owned and leased by the taxpayer.
 - c. Reviewing the insurance policy for equipment covered under the policy.
2. Compare the depreciable equipment from year to year to note if any of the equipment has disappeared.
3. Prepare an analysis of the pink slips of the vehicles (tractors, trailers, forklifts, etc.) on hand, and compare them with the assets on the depreciation schedule. If an asset does not have a pink slip, check the balance sheet for the corresponding liability. The absence of the pink slip or outstanding liability indicates that the asset has been disposed of by sale or other transfer.

Note: As with other receipts and refunds, agents should be aware that income from equipment sales may be diverted to the shareholder's personal bank accounts.

Fuel Sales

Many trucking companies have their own diesel pump at their terminal. The fuel pump is for use by the company drivers, but it may be used by the subhaulers. Fuel used by the subhaulers is deducted from their gross earnings. To account for the fuel sold to the subhaulers, there should be a corresponding credit to fuel expense or a credit to fuel sales.

Reimbursement of Subhauler Expenses

A prime carrier will often pay for expenses on behalf of the subhaulers and deduct the amount of the expenses from the gross amount earned by the subhauler. Common deductions from gross commissions or earnings include:

1. Worker's compensation.
2. Equipment rentals.
3. Administrative fees.
4. Insurance deductions for cargo insurance, property damage, personal liability, medical insurance, and life insurance, etc.
5. Fuel.
6. Uniforms.
7. Cargo claims (damages to delivered goods).
8. Traffic tickets.
9. Finance payments for trucks purchased by the subhauler.

Because it is a usual accounting practice of the prime carrier to deduct the gross amount paid to the subhauler, the reimbursement of the subhauler expenses should be credited to the expense or to an income account.

Expenses

The majority of the expenses deducted by a common or contract carrier are for direct operating expenses. The most significant expense is the cost of goods sold.

Cost of Goods Sold

Since the transportation of goods is the service offered for sale by the common and contract carriers, the costs relating to those services are usually deducted as cost of goods sold. These expenses may be classified as "other deductions." The most common operating expenses included in this category are:

1. **Subhauler Fees.** The subhauler fees are usually calculated as a percentage of the gross freight bills. A fixed hourly or weekly rate may be an indicator of a potential employment tax issue. A driver manifest is prepared by the dispatcher for

each day the subhauler works. The driver manifest (trip settlement sheet) contains the following information:

- a. Daily schedule of pickups and deliveries.
- b. Calculation of the subhauler's gross earnings.
- c. Additional fees earned for picking up ("spotting") empty containers.
- d. Expenses deducted from gross earnings.
- e. Ledger cards (which contain the posting of weekly earnings) used for the preparation of the Forms 1099.

2. **Detention/Demurrage Fees.** Detention fees are paid to a container company or to a steamship line for the failure to return containers timely. Demurrage is the charge by the railroad for failure to return the trailers in a timely manner. The grace period will vary based on the distance the trailer or container has traveled. While these fees are usually deducted as an expense, they can also be an income item. The trucking company will incur the expense for detention or demurrage and bill the customer for the charges if the delay is due to the fault of the customer (such as not taking delivery). The accounting entry would be to credit the expense or the income account.

- a. Thorne Neale & Co., 13 B.T.A. 490 -- Demurrage charges on taxpayer's freight shipments which taxpayer contested did not accrue and were not deductible until the ICC determined the taxpayer liability for the charges.
- b. Rev. Rul. 60-237, 1960-2 C.B. 164 -- Contested increase in per diem charge for rental of railroad car could not be accrued.

3. **Handling.**

4. **Trailer rentals.**

5. **Trip permits.**

Equipment Leasing

Trailers are the most commonly rented equipment since the number of trailers required to transport freight may vary. Trailers may be rented from a trailer leasing company for the daily, weekly, or monthly rates. In many instances, the trailers are owned by the shareholder or other related entity. If the transaction is with a related party, a fair rental value can be determined by contacting a local trailer rental company. Amounts in excess of the fair rental value may be disguised dividends or a method used to shift the tax liability.

When a common carrier leases the tractor from a subhauler, those rental fees are also reflected in this category. The subhauler agreement will specify the rental rates if they are separate from the fees earned.

Cargo Losses and Damage Claims

Claims may be filed for any of the following reasons:

1. Deposits in error.
2. Shortages of goods.
3. Damaged goods.
 - a. Visible damages to the carton.
 - b. Concealed damages to the goods within the carton.
4. Duplicate payments.
5. Overcharges on billings due to rating errors.

Documentation required to support these claims consists of the delivery receipt, the bill of lading, and the invoice remitted with the payment. The delivery receipt will note the number of items delivered and whether any visible damage was noticed by the driver or the receiver of the goods.

Errors in billing rates are usually corrected by reversing sales. The shipper or consignee will verify the billing rate prior to payment and will pay only the amount that should have been charged. When cash is received, the following accounting entry is made:

	<u>Dr.</u>	<u>Cr.</u>
Cash	\$90	
Sales	10	
Accounts Receivable		\$100

Factoring Fees

Factoring fees usually amount from 1 to 2 ½ percent of the accounts receivable factored, not including any chargebacks for the amounts uncollectible. The expense can be traced to monthly factoring statements for the accounts receivables. The statement will reflect the fees charged and any charge-backs.

Repairs and Maintenance

The agent should review the repairs and maintenance accounts to determine if the major repairs would prolong the life of the equipment. If so, under IRC section 263, these repairs should be capitalized.

Another method of extending the life of the fleet of vehicles is to refurbish the tractor by purchasing a "glider kit." A glider kit can be purchased at a fraction of the cost of a brand new tractor, and it only requires a mechanic's labor to rebuild the tractor unit. The labor associated with this reconstruction should be included in the cost of the capitalized repairs, and not deducted as wages. Other additions to the tractors such as computers, communication systems, etc. should also be capitalized. These additions may even result in the assessment of excise taxes.

DOT requires that maintenance and repair records be kept for each truck. Although these records would be most helpful in determining to what extent the repairs made prolong the life of the equipment, they are only required by DOT to be kept for one year. They may not be retained for the year under examination.

Depreciation

Since a brand new tractor is approximately \$75,000, most companies will purchase used equipment for less than half the cost of new equipment. For acquisitions of equipment made during the year, inspect the purchase contracts to determine if any units were traded in.

Verify that the units traded in were taken off the depreciation schedules, and that the depreciable basis of the asset was properly computed. Errors have been found in the following areas:

1. The basis of the equipment has not been reduced for the value of the trade-ins.
2. The equipment that has been traded in is still being depreciated.
3. The basis for the depreciation includes the cost of financing the purchase. Increases for financing have not been allowable.
4. The equipment is transferred between related entities to step-up the basis of the assets.

Dues and Subscriptions

There are various organizations that a company may belong to and periodicals that provide information on the transportation industry. Below is a list of some common organizations and periodicals:

Trade Association - American Trucking Associations.

Periodicals

1. Traffic World - Weekly magazine published by the Journal of Commerce, Inc. covering transportation by water, rail, and motor carriers. It contains articles about specific companies, changes in federal regulations, and trends in the industry.
2. Daily Commerce - Daily newspaper published by Airport Publishing Inc. contains current news articles and advertising by motor carriers, freight forwarders, and customhouse brokers.
3. Trucking Transport - National newspaper of the trucking industry that is published every Monday by the American Trucking Association, Inc.
4. Commercial Carrier Journal - Monthly magazine published by Chilton Company, for Fleet Managers.

In McClintock-Trunkey Co. v. Commissioner (1952) 19 T.C. 297, dues paid to a trucker's association and taxpayer's league organized to influence legislation are not deductible.

Schedule M-1

In preparing the pre-audit of the trucking company, the Schedule M-1 should be analyzed for the following non-deductible expenses and adjustments:

Traffic Citations

Almost all of the trucking companies audited failed to make an adjustment for traffic citations. Under IRC section 162(f), fines are a non-deductible expense. Although the adjustment is usually not very large, the following audit technique has been applied:

1. Scan the cash disbursements journal looking for payments to municipalities and to courts.
2. Determine which account the taxpayer is posting the disbursements to and then examine that account in more detail. Agents should be aware that some payments to courts and municipalities may be due to the garnishment of wages.

Reserves (self-insurance, uncollectible accounts, contingent liabilities)

Instead of paying premiums to an insurance company or agent, a company may set aside funds for contingent claims. Self-insurance reserves may be set up for all types of insurance a general freight carrier must maintain, such as cargo, workman's compensation, personal liability and property damage, and health insurance. Under IRC section 461(h)(5), a deduction for a reserve for estimated expenses is not allowable.

Extract

Rev. Rul. 81-93, 1981-1 C.B. 322.

*** Estimated insurance expenses are not deductible. The change from the use of estimates to the use of actual losses is a change in accounting method, and the balance in the reserve account at the beginning of the year of change must be included in gross income for that year.

* * * * *

U.S. v. General Dynamics Corp. 59 A.F.T.R.2d 87-899, the Supreme Court held that an accrual basis taxpayer which maintained a self-insurance plan for employee medical expenses, couldn't deduct its contributions to a reserve fund that reflected the amount the taxpayer estimated that it would have to pay for covered treatments received by its employees in a given taxable year, but which it had not actually paid out by the end of that year. See also Steere Tank Lines Inc v. United

States, 42 A.F.T.R.2d 78-5575 for self-insurance coverage for claims, and Specialized Services, Inc. v. Commissioner for the transfer of funds to an escrow trust fund to cover the insurance deductible.

Officers' Life Insurance

The schedule M-1 should be inspected to see whether the corporation is making an adjustment for officer's life insurance premiums that were deducted on the books. Per IRC section 264(a)(1), officer's life insurance premiums are not deductible if the employer is directly or indirectly a beneficiary of any part of the policy. The schedule M-1 should reflect an adjustment restoring the premiums to income. Under a split-dollar life insurance plan, which is described in Rev. Rul. 64-328, C.B. 11, not only is the corporation not entitled to a deduction for the insurance premiums paid, but the term portion of the premium should be reported as income on the return of the employee.

50 Percent Meal and Entertainment Limitation

IRC section 274(n) limits the deduction for meals and entertainment to 50 percent. While this adjustment is not unique to trucking companies or freight forwarders, many of them failed to make an adjustment for the limitation. A common error is the misclassification of meals and entertainment to another, less obviously titled account such as advertising, cost of goods sold, or employee benefits. An audit technique used to identify meal and entertainment expenses is to scan the cash disbursements journal for payments made to banks and credit card companies. Once the payments are traced to the expense account, the account can then be examined for other meal and entertainment expenses.

Payables

Generally, the accounts payable for a trucking company will consist of current expenses. At year-end, accruals are made for subhauler fees, detention or demurrage fees, and cargo losses if they can be reasonably estimated.

Other Liabilities

During the reconciliation of the general ledger to the tax return, the agent may find an account with one of the following descriptions:

1. Unapplied cash.
2. Customer credit balances.
3. Customer deposits.

These accounts represent duplicate payments, overpayments, or unidentified payments. If a customer does not pay the full amount of the invoice, the company will investigate the underpayment and make a correction to sales if the invoice was incorrect. If the invoice is correct, the customer will be notified of the outstanding receivable. If an overpayment, duplicate payment, or unidentified payment is received, ICC regulations, Title 49, Part 1008.9, states:

Extract

* * * * *

*** when a carrier does not have sufficient information with which to apply such payment, the carrier shall notify the payor of the unidentified payment within 60 days of receipt of the payment requesting information which will enable it to identify the payment. If the payor does not respond within 90 days, the carrier may treat the unidentified payment as a payment in fact of freight charges owing to it.

Under IRC section 451, the overpayments, duplicate payments, or unidentified payments should be included in income during the year they were received. See Boston Consolidated Gas Co. v. Commissioner, 128 Fed (2d) 473, 42-2 U.S.T.C. 9506. The courts held that deposits which were classified as liabilities and still outstanding were properly treated as income in the year in which the taxpayer treated it as available for its own use.

PETROLEUM CARRIERS

One of the companies audited, specialized in the transportation of petroleum products (such as, transporting gasoline from the refinery to the franchise or independent gas station). Since specialized equipment is needed, the petroleum carrier will usually own and operate a fleet of trucks. These trucks are known as vacuum tanks and consist of a tractor on an elongated chassis that accommodates one tank. A second tank can be hitched to the first chassis. The tanks themselves

are compartmentalized, so one tank can carry multiple grades and types of fuel.

A refiner may require the exclusive use of a certain number of units on a monthly basis and will enter into a "volume tender agreement" with the petroleum carrier. The tanks are then painted with the logos and colors of the refinery company, but the company's name will be painted on the cab, along with it's PUC and DOT numbers.

The petroleum carrier will probably have two 12-hour shifts every day, 7 days a week. The refiners usually handle the dispatching duties in order to stagger the loading times of the carriers' drivers so that time is not wasted waiting in line to load the petroleum products. The refiner will provide the drivers with:

1. A load ticket which indicates the amount and type of fuel loaded in the tanks, and the type and amount of fuel to be delivered; and
2. Dispatch instructions which lists where the fuel is to be delivered.

When the fuel is delivered, copies of the load ticket are distributed as follows:

1. One is retained by the refiner after loading the fuel in the tanks.
2. One is given to the station manager at the time of delivery.
3. The final copy is returned to the refiner for the carrier's records.

At the end of the drivers' shift, the load and volume tickets, are dropped off in a box at the refinery. The volume tickets and the load tickets are picked up by an employee of the carrier every morning.

Accounting Records

The petroleum carrier provides each driver with a volume ticket (VT). The volume ticket is the source document used in billing the refiner. The VT is a pre-numbered form which requires the driver to record the following information:

1. Number of gallons of fuel received.
2. Type of fuel.
3. Refinery name.
4. Hours spent delivering.
5. Waiting times (for demurrage charges).
6. Number of miles traveled.
7. Stations delivered to.
8. Other pertinent information needed by the common carrier for billing purposes.

The entries on the VTs are coded and input into the computer. These entries were summarized on a report called the "Edit Journal by Shipper." This report lists out each shipment by customer number. Each shipment is grouped together based on the number of shipments and products delivered (such as, 2-3 days' worth, or every day's total shipments, depending on the customer and number of deliveries made).

From the Edit Journal, the information is posted to:

1. A report called "Summary of Revenues by Shipper" which summarizes the daily revenues by refiner, commodity code, odometer miles, driver hours, revenue per mile; and
2. The invoices are generated and posted to the A/R Open File and GL. The invoices follow the same grouping format used in the Edit Journal. Invoices are generated daily when the information from the volume tickets are input into the computer.

In some cases, invoices are sent to the refiner after the amount of the invoice is confirmed with their own records to determine how much they should be billed. The turnaround time from the invoice date to the payment date is between 6 to 24 days. Payment discounts are not allowed.

Income

Income is derived from transportation charges billed to the refiner. The charges depend on the type of fuel, mileage, and whether the customer is charged by the load or by weight. A partial listing of the revenue classifications is provided in the following:

Commodity Code

- 111 Gasoline - Transportation charges based on mileage. The actual charges per mile are calculated by the petroleum company, based on its operating costs and profit margins. Rates may vary because of the distances involved, type of product transported, etc. The number of miles are taken from the Metropolitan Zone book which lists standardized mileage from one zone to another.
- 223 Demurrage - Fee charged for excess delivery time. The normal time for loading fuel at the refinery and unloading it at the station is 1.5 hours. If the actual time for loading and unloading is longer than that, the refiner is charged in 15-minute increments for the additional time spent loading and unloading the fuel. The time allowed may be exceeded because there are too many tankers waiting to load up at the refinery or there may be cars parked over the underground tank openings at the station.
- 224 Stop-in-Transit - Fee charged for delay time due to rerouting of the delivery. Fee is based on one hour increments. If the driver is unable to "dump" the fuel load, the dispatcher may reroute the driver to another station or have the driver return the load to the refinery.
- 227 Pump Charge - An hourly rate charged for pumping fuel from the truck to above-ground storage tanks. Stations with above-ground tanks have the fuel pumped from the truck to the tanks, rather than allowing the fuel to follow the force of gravity and flow into the underground tanks.
- 228 Light Weight - Fee charged for weighing the truck before and after delivery to determine the weight of the load for "by the pound" billings.
- 230 By-the-Load - Fixed fee per load.

- 231 Empty Miles One Way - A refiner may have multiple refining-storage facilities and the driver are instructed to go to this or that refinery rather than the one closest. If the miles traveled empty exceed the miles loaded because of this rerouting, the customer is charged at a set rate per mile multiplied by the miles exceeding the loaded miles.
- 232 By-the-hour - Fee charged for the refusal of a shipment. If a full load can't be delivered to a station, the station manager will usually refuse to accept a partial delivery. The driver will then contact the dispatcher to be rerouted to another station or directed back to the refinery to pump out the fuel so that the station can be credited for the fuel not delivered.

Expenses

The majority of expenses incurred by an exempt carrier are similar to those of common and contract carriers. The expense for cross-dumping was found to be limited to petroleum carriers.

Cross-dumping - Fuel is sometimes lost due to spillage or "cross-dumping" (being pumped into the wrong under- ground tank). If unleaded and super unleaded are mixed together, the carrier will be charged for the difference between the two grades of gas. If incompatible types are mixed (for example, regular gas mixed with unleaded gas, or diesel mixed with regular or unleaded gas), then the underground tanks have to be pumped out.

When cross dumping occurs or if fuel is lost due to spillage:

1. The station owner will contact the refiner so they will not be charged for the fuel.
2. If cross-dumping has occurred, the petroleum carrier is also responsible for the following:
 - a. Pumping the fuel out of the tank with their own pump tanker and returning the fuel to the refiner for reprocessing.
 - b. A processing fee.
 - c. Delivering the replacement load of fuel free of charge.

LABOR LEASING COMPANIES

Labor leasing companies act as an employment agency for union drivers, cargo handlers, and owner-operators. Clients of a labor leasing company are usually private carriers and warehouses. The private carriers will usually have their own fleet of vehicles, but they need reliable and insured drivers.

The labor leasing company will negotiate separate contracts with their client and the union providing the labor. The labor leasing company will hire the drivers, cargo handlers, or accounting personnel as employees. It will instruct them as to where they will be working. The union drivers are paid an hourly wage rate and receive union benefits, such as health, dental, and life insurance and a pension plan as required by the union contract.

The labor leasing company can hire non-union employees, but these laborers are not provided the same benefits as their union counterparts.

Accounting Records

Due to the nature of the business, the accounting records are rather simple. Source documents consist of the following:

1. Contracts between the union and labor leasing company.
2. Contracts between the labor leasing company and their client.
3. Time cards for the employees.
4. Billing invoices for services rendered.
5. Employment tax information.

Income

The labor leasing company derives its income from administrative fees. They invoice the following elements: wages, employment taxes, workman's compensation, union benefits, and an administrative fee. Invoicing occurs weekly, which enables them to meet the prior week's payroll. Payment is due within 7 days.

Expenses

Since this is a labor intensive business, the majority of the expenses incurred will be for wages, employment taxes, workman's compensation, and union benefits. Expenses which do not appear to be labor related should lead an agent to question the business purpose of the expense.

Although the primary purpose of labor leasing is to ensure a reliable workforce for a company, agents should be aware that the use of leased employees by a company may result in possible pension discrimination and the disallowance of pension plan contributions.

Leased Employees

Employee leasing is among the fastest growing service industries; particularly among businesses with 35 or fewer employees. Although widespread employee leasing is relatively new, it has been used by the trucking industry for many years. Three factors in particular have contributed to the growth of the employee leasing industry:

1. Small companies want to avoid the administrative work involved in keeping payroll records and filing payroll tax returns.
2. Small companies are unable to offer the same fringe benefits as larger companies. Leasing organizations, by pooling the leased employees and their own staff, can provide greater benefits at a lower cost.
3. Employee leasing has been used as a tax shelter in pension planning. In a typical employee leasing arrangement, the recipient of the services terminates some or all of its employees and then leases back the same workers for the same jobs, but as employees of the leasing agency. The workers work full time for the recipient, and their duties are indistinguishable from their previous relationship as employees of the recipient.

Once this arrangement is entered into, all administrative responsibilities, such as payroll preparation, benefits administration, and Federal and state returns, become the responsibility of the leasing organization. The recipient of the service pays a fee to the leasing agency on top of all of the expenses that the leasing agency incurs for that employee. The

possible area of abuse in employee leasing centers around pension plan discrimination.

The Employee Retirement Income Security Act of 1974 required that all employees be considered in determining the tax status of a company's pension plan. Employers were able to circumvent this requirement by establishing separate organizations. In this manner, the business entity that employed the preferred employees could qualify its pension plan without concern for the non-discrimination rules of IRC section 401.

The enactment of IRC section 414(m) in 1980 created the concept of "affiliated service groups," under which all such organizations are considered to be a single employer for the purpose of pension plan provisions. This was intended to end the exclusion of non-key employees from the pension plan.

The Tax Equity and Fiscal Responsibility Act of 1982 added new provisions to the tax code. IRC section 414(n) was added and specifies that leased employees will be treated as employees of the recipient if the following conditions are met:

1. There is an agreement between the leasing organization and the recipient of the employee's services.
2. The services are performed on a substantially full-time basis for at least one year.
3. The services are of the kind that have been performed historically for this business by its employees.

The Deficit Reduction Act of 1984 amended the leasing provision of IRC section 414(n) so that leased employees who do not meet the above tests will nevertheless be treated as employees of the recipient if the common law tests of an employer-employee relationship are met. Hiring, firing, and in general, exercising control over the employees would indicate that an employer-employee relationship exists.

The entire legislative history of employee leasing consists of attempts to prevent the exclusion of non-key employees from company pension plans. It is still possible, however, to exclude these employees because IRC section 414(n) provides a safe harbor rule [IRC section 414(n)(5)]. The recipient may exclude these individuals if the leasing organization provides

its employees with a qualified purchase pension plan. This plan must provide the following:

1. Each employee of the leasing organization must be a plan participant, except employees who perform services primarily for the leasing organization or those who earn less than \$1,000 per year.
2. For services performed after 1986, contributions to the plan must be at least 10 percent of each employee's compensation. Contributions must be made regardless of any age or service requirement. (Prior to 1987, the contribution rate had been 7.5 percent.)
3. Employees' vesting rights must be immediately forfeitable under IRC section 411(a).
4. The plan must satisfy the coverage and non-discrimination rules of IRC section 401(a) for all employees of the leasing organization.

Even if there is a qualified plan maintained by the leasing organization, its employees will still be counted in the recipient's plan. They are covered by such plan if the recipient's plan relies on the existence of the safe harbor plan to meet the qualification requirements. A leased employee will be treated as an employee of the recipient, regardless of the existence of a safe harbor plan, if leased individuals account for more than 20 percent of the recipient's non-highly compensated work force for its plan year. IRC section 414(q) defines "highly compensated" as anyone who during the current or preceding year met any of the following requirements:

1. Was a 5 percent owner at any time during the year.
2. Received compensation in excess of \$75,000.
3. Received compensation in excess of \$50,000 and was a member of the top paid group of employees, where "top paid" means the top 20% of employees when ranked by compensation paid during the year.
4. Was an officer at any time and received compensation greater than 50 percent of the annual benefit amount in effect under IRC section 415(b)(1)(A).

Because it is a common practice in the trucking industry to lease drivers, this area should be an area addressed to determine if the trucking company is properly administering its pension plan. If the

trucking company is leasing any of its employees, the following must be determined:

1. Are the leased employees included in the company pension plan?
2. If the leased employees are not included in the company plan, the following questions need to be addressed:
 - a. Is the percentage of leased employees to the total number of employees greater than 20 percent? If the answer is yes, then they should be included in the company's pension plan.
 - b. Does the leasing organization provide a pension plan for those leased employees in accordance with the "safe harbor" provisions in IRC section 414(n)(5)?
 - c. If the leased employees are not included in the company's pension plan, or a safe harbor plan, are they union employees? If they are union employees, were retirement benefits the subject of good faith bargaining between employee representatives and the employer? [See IRC section 410(b)(3)(A)].

INDEPENDENT CONTRACTORS

Although some trucking companies have their own fleet of trucks and trailers and hire employees to drive them, most trucking companies will engage the services of independent contractors. By using the services of independent contractors, the company can reduce its cost of operations by:

1. Engaging only the number of independents as is necessary to handle the freight moves which have been scheduled.
2. Shifting the expense for property and liability insurance, cargo and workman's compensation insurance, vehicle registrations, repairs, and fuel expense to the independent contractor.
3. Eliminating other employee benefits such as medical and dental coverage, life insurance, pension benefits, sick pay, and vacation pay.

Types of Independent Contractors

Owner-operators - An owner-operator owns and operates his or her own truck (that is, tractor-trailer or bobtail). The owner-operator should have operating licenses from the ICC and PUC. A prime carrier may hire them as subhaulers. Income earned is a percentage of the freight bill prepared by the prime carrier.

Subhaulers - A subhauler is an owner-operator of a single tractor or may have a fleet of tractors which are leased to prime carriers. A subhauler with a fleet of vehicles may be liable for employment taxes on the drivers of those vehicles. Income earned is a percentage of the freight bill prepared by the prime carrier.

Porthaulers - An owner-operator whose primary route is to pick up freight from the harbor and to transport the full, sealed container to the terminal of the prime carrier or break-bulk agent. Porthaulers are usually paid a flat rate for each container hauled.

Operating Authority

Under the PUC regulations, each owner-operator hauling intrastate freight must have a PUC license. However, an owner-operator can haul interstate freight without an operating permit if they lease their equipment to a common carrier with operating authority or operate within a 20-mile radius of the harbor.

Selection of Subhauler Returns for Audit

Due to the numerous subhaulers and independent contractors hired by a prime carrier during any tax year, certain procedures and criteria were used to identify subhauler returns with audit potential.

Identifying potential subhauler returns for audit begins with the package audit and compliance checks of the prime carrier. A recommended approach to selecting subhaulers and identifying nonfilers for examination is outlined in the following steps.

Determine Whether Information Returns Were Properly Filed

Determine whether the Forms 1099 were issued by requesting copies of all Forms 1099 filed and the Form 1096 from the taxpayer. Compare this to the number and dollar amount of the Forms 1099 filed with the Service Center by requesting a PATRA or PMFOL. If the Forms

1099 were not filed with the Service Center, the agent or examiner should consult with their manager about expanding the audit to include the subhauler returns to ensure that the income has been properly reported. As an alternative, back-up withholding should be considered.

Identify Disbursements to Selected Subhaulers

The trucking company will keep a summary of the amounts paid to the independent contractors to be used in the preparation of the Forms 1099 at the end of the year. Tracing the cash disbursements to this list will determine whether the amounts on the Form 1099 were properly reported.

Verify the TIN/EIN Numbers

Each corporate subhauler or independent contractor should complete a W-9 for the prime common carrier when hired. Agents can determine the status of the subhaulers and independent contractors by requesting copies of the W-9 filed with the prime carrier. Since Form 1099 is not required to be issued to corporations, subhaulers may provide the EIN issued for filing Form 2290, Heavy Vehicle Use Tax. A transcript on the EIN should verify the validity of the EIN provided. Lack of information or records may indicate the use of an improper EIN or a nonfiler.

Verify Earnings - "Gross" vs. "Net"

If the Forms 1099 were issued, the next step is to determine whether the correct amount of earnings was reported. The Form 1099 should reflect the gross amount of earnings. To determine whether the Form 1099 was issued at "gross" vs. "net," the agent should compare gross earnings on the drivers' manifest, settlement sheet, and trip tickets with the total on the Form 1099. If the Forms 1099 were issued at net, consideration should be given to expanding the examination to the subhauler returns to verify that deductions were not claimed twice. Once, by reporting the net amount of earnings on Form 1099; and again, by claiming the deductions from gross earnings on the settlement sheet.

Request IRP Reports, Transcripts, and Tax Returns

Once the subhaulers have been identified, the following forms should be submitted:

1. Form 6632 - IRP transcript request.
2. Form 5345 - Return requisition.
3. Form 6882 - Transcript request of the taxpayers' account.

The transcript will indicate whether a tax return has been filed for the tax year. The IRP transcript will list out all Form 1099s issued to the subhauler and should be compared to the Schedule C of the income tax return. In addition, a RTVUE can be obtained for 1989 (and later) individual income tax returns. A RTVUE is an IDRS print-out which shows the line by line amounts on the Form 1040.

Documents to Secure From the Prime Carrier

If it appears the subhauler has failed to file a return, the agent should accumulate as much of the following information as is available for each subhauler in order to verify and support the determination of gross income:

1. A copy of the Form 1099 issued to the subhauler.
2. A copy of the payment ledger or manifest summary showing all disbursements to the subhauler.
3. Copies (front and back) of all canceled checks issued to the subhauler.

Note: Even if the subhauler may be including the entire amount from the Forms 1099 on his or her return, other bank accounts may be identified by reviewing the endorsements on the backs of the cancelled checks. By contacting these banks, other sources of income for which a Form 1099 was not issued may be identified.

4. Any identification information that the prime carrier may have on the subhauler, such as past and current addresses, telephone number, PUC or ICC permit information, vehicle identification numbers (VIN), and license number, etc.

While most of the audits began with the corporation and were expanded to include the subhauler returns, the converse can occur. During the examination of a subhauler there may be indicators which will lead to corporate examinations, and include but are not limited to:

1. Determining whether unreported income is from prime carriers that did not issue information returns. The prime carrier may be liable for employment taxes and penalties for failure to file the proper information returns.
2. Leasing equipment from the prime carrier may be an indicator that the subhauler should be classified as an employee.
3. Cash payments made by the subhauler to the corporation, or its officers may be omitted as income.

Accounting Records

Independent contractors in the trucking business are not known for keeping a formal set of books and records. They usually keep canceled checks and receipts in an envelope or shoe box. In addition, they should be keeping copies of the trip settlement sheets or manifest summaries provided to them by the prime carrier.

Income

The gross receipts reported by the subhauler usually equals the total earnings reported on the Forms 1099 received from the prime carriers.

IRP transcripts should be requested early in the audit to determine if all Form 1099 income has been reported. Most prime carriers appear to be filing Forms 1099 for subhaulers and independent contractors. In one case, however, no Forms 1099 were issued at all. Both the CPA and the taxpayer believed that the other was filing them. If a prime carrier did not issue Forms 1099, there is a higher probability this income was not reported on the subhaulers income tax return.

In addition to reviewing the Forms 1099, other methods used to determine income were:

1. **Bank Deposit Analysis** - As with a trucking company, a bank deposit analysis may reveal unreported income from the sale of assets. However, the likelihood is rather slim because it appears that

most subhaulers do not deposit their checks in the bank. Instead, the checks are cashed at the corner market, liquor store, gas station, or by check cashing services.

2. **Cash-T** - Due to the fact that most of the checks received are not deposited in a bank account, preparing a Cash-T has been an alternative method for determining gross receipts. In most cases, the Cash-T resulted in adjustments to gross income since the applications or use of funds was greater than the sources of income.
3. **Other Income Sources** - The subhauler may have additional fees from hauling empty containers, sale of equipment, or the sale of excess, unclaimed, or damaged goods. These sources are probably best determined through questioning during the initial interview.
4. **Other Audit Techniques** - Contact the insurance company that issues the "certificate of insurance" to the prime carrier to help identify other companies that the subhauler may have worked for during the years under examination. Then, contact the other prime carrier(s) to obtain copies of the Forms 1099 and/or amounts paid to the subhauler.

Expenses

Most of the time, the prime carrier will deduct expenses incurred for cargo and workman's compensation insurance, fuel, cost of replacement parts, other repair expenses, PUC fees, cargo losses, traffic violations and/or other miscellaneous expenses paid on behalf of the subhauler. These deductions are made from the gross earnings of the subhauler and are reported on the trip settlement statements or manifest summaries prepared by the prime carrier in determining the amount to pay the subhauler. A copy is provided to the subhauler at the time the check is issued.

If the "gross" amount of earnings is reported on the Form 1099 issued to the subhauler, the subhauler is entitled to the deductions on the individual income tax return. However, if the amount of earnings reported on the Form 1099 is "net," it is important to verify that the subhauler is not claiming a deduction for the expenses on the individual tax return.

Typical expenses on a subhauler's tax return (usually a Schedule C on their individual return) are the following:

1. **Fuel** - If the prime carrier has its own fuel pump, the subhauler will quite often purchase fuel from the prime carrier. Or, the subhauler will purchase his or her fuel from stations specializing in diesel fuel. In either case, the subhauler should have invoices, trip settlement statements, or manifest summaries to verify the expense deducted on the return.

There are two problems to be aware of in verifying this expense. First, in addition to purchasing fuel, the subhauler would write checks to the service station to receive cash, and then use the canceled checks as support for the fuel deduction. Second, subhaulers will use an invoice and the canceled check paying for that invoice as support for two separate deductions.

2. **Maintenance and Repairs** - This may be a rather large expense depending on the age of the equipment. If this expense is examined, consideration should be given to the capitalization of the expense.
3. **Tires** - Usually handled as a prepaid expense for the larger operators. Sometimes, the examiner will find the taxpayer has reduced the basis of the truck by the estimated value of the tires, with the tires being treated as a current deduction.

Rev. Rul. 59-249, 1959-2 C.B. 55, allows that the cost of tires and tubes purchased on new commercial trucking equipment and used in motor freight transportation is deductible in the taxable year of purchase. However, the tires must be consumable within that year or their average useful life is less than one year.

4. **Insurance** - The independent contractor is responsible for property and liability, cargo, and workman's compensation insurance. The cost for cargo and workman's compensation insurance coverage is usually paid for by the prime carrier so they can be sure the goods and subhaulers are covered. To verify the expense, review the trip settlement statements or manifest summaries. For other insurance coverage, such as property and liability coverage, review the premium statements and policies.

5. **Drivers** - Subhaulers may have more than one truck and will hire other drivers for these vehicles. These drivers are usually treated as independent contractors. They are issued Forms 1099, or nothing at all. Potential employment tax issues are (1) whether the independent contractors are employees or (2) if they are independent contractors, whether the proper information returns were filed and filed correctly.

The assessment of back-up withholding under IRC section 3406 should be made on the employment tax report, Forms 2504, 4666, and 4668 if:
 - a. Required Forms 1099 were not filed or issued.
 - b. TINs were not provided or are invalid.
6. **Licenses** - A vehicle is required to be registered with the DMV in each state that it operates. If a subhauler crosses state lines, the registration fees can be apportioned between the states. If a subhauler operates as a common carrier, he is or she required to have a PUC license and/or ICC license.
7. **Taxes** - The heavy vehicle use tax is the liability of the registered owner of the vehicle. The tax is due on a highway motor vehicle having taxable gross vehicle weight of 55,000 pounds or more. Since a copy of the Form 2290 must be provided upon registration of the vehicle with the DMV, most subhaulers file "exempt" (meaning that the gross laden weight falls under 55,000 pounds) or under an incorrect weight classification.
8. **Depreciation** - The subhauler should be able to provide the documentation to verify ownership and basis of the vehicle. When new equipment is purchased and the old equipment is traded in, the basis of the new equipment will need to be adjusted for the trade-in value and the accumulated depreciation on the trade-in.
9. **Leased Equipment (usually trailers)** - In most circumstances, the subhauler does not own trailers. They usually rent the trailer from the prime carrier. If this is the case, the prime carrier deducts the amount from the subhauler's gross pay. If the "gross" income is reported by the subhauler, then he or she is entitled to a deduction.
10. **Truck Wash** - A common but relatively small expense.

11. **Travel** - For most local truck drivers and subhaulers, travel is nonexistent. However, long distance truck drivers may deduct travel expenses if they can substantiate expenses in accordance with Treas. Reg. section 1.274-5(a). Truck drivers must keep receipts or maintain a log with such information as the amount, time, place, and business purpose of the travel expense incurred. A truck driver who maintained a log book with cities, distance, and driving time was not allowed to deduct estimated travel expenses (Boul, Bernard H., T.C. Memo. 1976-336, 35 TCM 1544). Keeping track of the number of hours driven and the number and duration of the stops was not enough to support a deduction for travel expenses in the case of Johnson, Carl, 1970 P-H T.C. Memo. 70-134, 29 TCM 602.

Multiple Owner-Operators Using the Same DBA

During the audit of an owner-operator, the individual used three different names for his trucking business (his personal name, his personal name "DBA" Trucking, and "DBA" Trucking). The "DBA" Trucking was a PUC authorized partnership entity with four co-partners. All four co-partners operated out of the same truck yard and each operated their own separate business.

One owner-operator had two checking accounts - one under his and his wife's name, and another in the name of "DBA" Trucking. The same owner-operator rented trucks to his co-partners and obtained insurance for all equipment owned and operated by the co-partners. He was reimbursed for the insurance and the lease of the trucks by the co-partners.

Most of the expenses, especially the larger ones like fuel, repairs, and maintenance were purchased under the name of "DBA" Trucking. Upon inspection of the receipts and invoices during the audit of the prime carrier, it appeared that they were signed by either drivers of the co-partners or by the co-partners themselves. When these expenses were analyzed on the individual co-partner's return, the co-partner deducted expenses attributable to the other co-partners, thereby creating a double deduction.

In cases where there has been a determination of unreported income and duplicate expense deductions, agents should consider filing Form 2797, for fraud referrals for a potential fraud case.

SHIPPER'S AGENTS

Originally, shippers' agents were brokers for the railroads to sell space on railroad cars. Today, they are still brokers of railroad transportation. However, they have expanded to include authorized motor carriers and steamship lines.

Agent - Principal Relationship

The shipper's agent is a bonafide agent of the shipper who performs the shipper's transportation function. The shipper's agent arranges for and routes the transportation of goods from one point to another. Other duties may include the settlement of claims and payment of the carrier's freight invoices. Ultimate payment of freight bills, however, is the responsibility of the shipper.

As an agent of the shipper, they are not regulated by the ICC. The shipper's agent does not take possession of the goods transported nor do they issue a bill of lading. Instead, the bill of lading is prepared by the shipper. Each carrier engaged in the transportation function (common carrier, steamship company, railroad) assumes responsibility for the goods while they are in transit.

Since the shipper's agent does not take title to the goods, it is important for them to track the movement of each shipment. They do this through a computer network that can track the movement of each shipment by trailer or container number.

The shipper's agent will enter into rate contracts with railroads, contract carriers, and steamship lines. The rates are based upon the routes and the estimated volume of freight to be shipped during the contract period. They will then route the freight using the best price available.

Accounting Records

Shipper's agents maintain a double-entry set of books, much the same as those described for freight forwarders and common carriers. Assets of the company consist primarily of office facilities and perhaps warehousing space. Since they are not required to have an operating license, they will not own trucks. They will not have a terminal.

Income

Income is usually recorded on the accrual method. However, shipper's agents may attempt to report their income net of expenses to avoid exceeding the \$5 million gross receipts test of IRC section 448. By doing this, they are allowed to remain on the cash method of accounting. However, per Treas. Reg. section 1.448-1T(f)(2)(iv), they are not allowed to reduce gross receipts by cost of goods sold.

At the time the shipper notifies the shipper's agent of a shipment, a price quote is provided and the income is accrued. The shipper's agent then bills the shipper for all transportation costs plus a fixed amount for services rendered once the shipment is delivered. Extra charges for transloading, driver waiting time, and driver loading will be included in the invoice to the shipper.

Railroad Rebates

As incentives for shipper's agents to use the railroads, quarterly rebates are made based on the volume of goods transported. The rebates are generated by the railroad and calculated on a percentage of the total revenues billed to the shipper's agent during the quarter.

The shipper's agent that we examined did not accrue the rebate since they were unable to track the freight charges incurred with each of the railroads.

Expenses

The shipper's agent can accurately estimate the costs to be incurred for the railroad, shipping, and other transportation. Because the costs can be reasonably estimated, they are accrued at the same time the income is accrued. The typical accounting entry is:

Dr	Railroad
Dr	Cartage (drivers)
Dr	Transportation costs (other common carriers)
Dr	Detention (or demurrage)
Cr	Accounts payable or Freight payable

The actual payment of the expenses usually occurs within 30 days after the transaction has been completed. Operators authorized by the ICC will

require payment within 7 days. The shipper's agent will have freight bills from the railroads and common carriers to support the above charges.

To expedite payment, many of the railroads will "draft" or debit the shipper's agent bank account each week for the prior weeks freight bills. The railroad notifies the shipper's agent of the freight invoices to be paid, the amount of the electronic transfer, and the date of the designated debit or draft. Then, on the designated date, the funds are transferred to pay the freight bills.

An internal variance report is generated which compares the accrued expenses with the actual costs incurred. If the actual expenses are less than the accrued expenses, then income from the variance is recorded. If the actual expenses are greater than the accrual, the excess is expensed at the time of payment.

Insurance

Although shipper's agents are not responsible for loss or damaged goods, they will carry cargo insurance to protect themselves from liability.

Trade Associations

1. Air Transport Association.
2. Foreign Trade Association.
3. International Air Transport Association (IATA) - This organization governs and standardizes the industry of air freight forwarding. They establish the maximum standard air freight rates and set minimum financial standards and reporting requirements. Membership is not mandatory but helpful.

Trade Publications

1. Air Cargo World (for air freight forwarders).
2. American Shipper International (for shippers, brokers, and forwarders).
3. Daily Commerce News (for motor carriers, freight forwarders, and customhouse brokers).
4. Global Trade Talk (U.S. Customs service journal for the international trade community).

FREIGHT FORWARDERS

Freight forwarders offer the combination of services provided by a shipper's agent and a common carrier in handling the transportation of goods from one point to another.

Types of Freight Forwarders

Freight forwarders usually specialize in the type of freight transported and the type of transportation carriers used. This provides them with expertise in handling the paperwork involved with certain types of transactions.

1. **Common Carriers** - A freight forwarder performs the same function as a shipper's agent, but has operating authority from the ICC as a common carrier. As a common carrier, they assume the responsibility for the freight by taking title to the goods and issuing their own bill of lading.

Other services which can be offered to the shipper include cartage, warehousing, transloading of goods, deconsolidating shipments as the break-bulk agent, and clearing customs as the customhouse broker.

2. **Air Freight Forwarders** - Air freight forwarders primarily handle the transportation of foreign goods into the country (import) and of domestic goods out of the country (export). At this time, air freight forwarders are unregulated but industry standards are set by IATA.
3. **Consolidators** - A consolidator purchases container space below the market price established by the carrier and sells the container space to other freight forwarders. The difference between the purchase price and sales price is the profit. The consolidator normally has six months to a year to fill the container space. If the consolidator is unable to fill the container, the carrier does not charge the consolidator for the unfilled space, however, this factor will enter into subsequent negotiations for container space.

When the consolidator packs the goods for the shipper, they will prepare a shipping invoice and a packing list. The shipping invoice will list the items being shipped along with their value, while the packing list will only show the items being shipped. The packing list is provided to the

break-bulk agent at the destination point so they can breakdown the shipment and compare what was received with what was shipped.

4. **NVOCC** - An ocean freight forwarder is called an NVOCC (non-vessel operating common carrier) and must be registered with the Federal Maritime Commission.

Prior to 1975, the ICC regulated the operations of freight forwarders. The ICC defines a freight forwarder as a person holding itself out to the public to provide the transportation of property for compensation in interstate commerce. In general, they handle the functions of the shipping department for their client. The functions and duties of a freight forwarder consist of, but are not limited to:

1. Assembling and consolidating shipments.
2. Preparing the shipping documents (bill of lading, packing list, and invoices).
3. Providing or arranging the transportation for the pick-up and delivery of shipments to the cargo carrier.
4. Performing or arranging the break-bulk, transloading, and distribution of the container shipments.
5. Providing or arranging the delivery of the goods to the final destination.
6. Assuming responsibility (bonded) for the transportation from place of receipt to the place of destination by issuing a bill of lading.
7. Paying for expenses on behalf of the shipper or consignee.

The success of a freight forwarder is determined by his or her ability to negotiate favorable rates with different carriers. Their profit margin is the difference between the freight rates charged to the shipper and the rates paid to the carriers. As a basis for negotiating with air cargo carriers, the standard air cargo rates, the "tariff rate," published by the International Air Transport Association (IATA) in the "Air Cargo Tariff" will be used. The objective is to negotiate air cargo rates which are less than the

standard tariff rates. The freight forwarder will also negotiate contract rates with a common carrier if they cannot provide the service themselves.

Types of Shipments

Air freight forwarders handle both imports and exports and any type of freight, such as movie sets, cars, agriculture, raw materials, finished products, and even animals. The cost of the shipment will depend on what is shipped, how it is shipped, and the type of shipment. Listed below are examples of the different types of shipments:

1. **Direct Shipment** - Most expensive method of transportation, usually by air, for shipments of perishable goods which need immediate attention (for example, fresh fruit and vegetables, animal products). The carrier will use the higher rate determined by either:
 - a. "gross weight" - actual weight of the shipment.
 - b. "volume weight" - size of the goods being shipped (for example, styrofoam goods).
2. **Consolidated Shipment** - If an airfreight shipment is less than 220 lbs. and not urgent, a consolidator will combine many shipments of unrelated shippers into one shipment so the airline's minimum weight limitation of 220 lbs. is exceeded. Problems can arise with a consolidated shipment if one of the shipments is unable to clear customs. All shipments within the container will be delayed, until all shipments clear customs.
3. **Co-Load** - When a freight forwarder does not have enough weight to ship, the shipment can be combined with another freight forwarder. Each co-loader prepares a House Air Way Bill (HAWB), shipping invoice, and packing list. A Masterhouse Air Way Bill (MAWB) is prepared for all shipments in the container. Thus, if a problem arises in clearing customs, only the shipment with the problem will be delayed.
4. **Free House Delivery** - The shipper pays for all transportation costs attached to this type of shipment which includes the sending of gifts, introductory products offered to distributors in foreign countries, or to a consignee in a foreign country that is unable to pay for the transportation cost due to the small size of their operations.

Accounting Records

The freight forwarders examined kept normal, double-entry sets of books. However, some of the important source documents generated are attached to sales invoices, and retained by air freight forwarders were:

1. **House Air Way Bill (HAWB)** - A HAWB is the bill of lading which is prepared by an air freight forwarder for each individual shipment of goods. The responsibility for issuing the HAWB is on the shipper (exporter) or the shippers freight forwarder. However, if the freight is being shipped by an ocean vessel, the bill of lading is issued by the Non-Vessel Operating Common Carrier (NVOCC).
2. **Master Air Way Bill (MAWB)** - The MAWB is issued by an air freight company. The MAWB summarizes all of the HAWBs and describes all of the consolidated shipments in a particular container. If the goods are shipped by ocean vessel, the corresponding document is the master billing of lading.
3. **Form 7501** - This form is issued by U.S. Customs. It contains a summary of the freight being imported and the customs duty to be collected. This is the freight forwarder's support for custom duties paid.

Income

Income is reported under the accrual method of accounting and is derived from billing either the shipper (prepaid) or the consignee (collect) as indicated on the bill of lading. The sales invoice usually includes an itemization of the following income categories:

- | | |
|-------------------|-----------------------|
| 1. Cargo carrier | 5. Commissions |
| 2. Common carrier | 6. Handling |
| 3. Break-bulk | 7. Cartage or drayage |
| 4. Warehousing | 8. Insurance |

Most freight forwarders will reflect the gross amount of income and expenses on their tax return. However, the income is reported net of expenses, agents should refer to the cash vs. accrual section under "Shipper's Agents."

When a domestic freight forwarder engages the services of a foreign freight forwarder, they will issue a

settlement statement for services rendered. The settlement statement lists the MAWB numbers, the foreign freight forwarder's lot or other identifying number, and the amount due to the foreign freight forwarder (on collect shipments) after subtracting the U.S. freight forwarder's commissions.

Wire transfers appearing on the bank statements should be traced to debits in the subsidiary ledger for the foreign freight forwarder and to the settlement statements. If these wire transfers do not reconcile to the amounts on the settlement statements or subsidiary ledgers, further analysis is necessary to determine where the funds are transferred to and the reason why. The company may be wiring money offshore to foreign accounts of the shareholders or related entities.

Gain or Loss on Foreign Currency Transactions

Since freight forwarders deal with importing and exporting goods, they may encounter foreign currency transactions in the valuation of goods and services. Foreign currency fluctuations result from the difference between the exchange rate at the time of billing and at the time of payment. A freight forwarder that must make payments to a foreign entity in their currency will try to buy the foreign currency at the best exchange rate possible.

Although the gain or loss may not be a major item, it would still warrant examination to ensure that the gain or loss has been reported correctly. To verify the gain or loss, the examiner would want to inspect:

1. The invoice from the foreign entity which establishes the liability in the foreign currency and the exchange rate on that day.
2. The receipt from the financial institution selling the foreign currency to the freight forwarder.

By inspecting these documents, the examiner should be able to verify the gain or loss from the currency transactions. If there is no gain or loss reported on the return, the cash disbursements journal should be inspected for payments to foreign or domestic banks which may represent purchases of a foreign currency. Sampling the outstanding accounts payable may also reveal unreported gains on currency transactions.

Insurance Premiums

The shipper is provided a limited amount of insurance coverage for damage or destruction by each carrier in the transporting of goods from port-to-port. However, due to the value of the shipment, additional coverage may be desired. As an additional service for their customers, many freight forwarders will act as insurance brokers in arranging for cargo insurance. For providing this service, they will receive a commission which should be reported as income.

Expenses

The major expense of the freight forwarder is the cost of transporting the goods. Other expenses consist of cartage costs, handling fees, terminal fees, brokerage charges, and insurance premiums.

Accounts Payable

When a freight forwarder is contacted by a shipper to perform services, they are able to accurately estimate the transportation expenses, customs duties, and insurance costs. The freight forwarder will accrue these expenses at the time the sale is recorded, but before they receive any invoices for services. When the invoices are actually received, there may be a difference between what was accrued and the amount paid.

Extract

Treas. Reg. section 1.461-1(a)(2)(ii) and (iii)(A).

(ii) *** no liability shall be taken into account before economic performance and all of the events that fix the liability have occurred, the fact that the exact amount of the liability cannot be determined does not prevent a taxpayer from taking into account that portion of the amount of the liability which can be computed with reasonable accuracy within the taxable year. ***

(iii) *** (A) If any provision of the Code requires a liability to be taken into account in a taxable year later than the taxable year ***, the liability is taken into account as prescribed in that Code provision. ***

Treas. Reg. section 1.461-1(a)(3) states "*** that if a taxpayer ascertains that a deduction was improperly claimed in a prior taxable year, the taxpayer should, if within the period of limitations, file an amended return and pay any additional tax due."

However, if the amount of the accrued expense is billed incorrectly and the unbilled portion remains an outstanding liability on the books, the question arose as to whether the liability should be brought back into income currently or after the state's statute of limitations for civil action has expired. In Bear Manufacturing Co. v. United States, 430 F.2d 152 (7th Cir. 1970) the courts relied on the taxpayer's reversal of the liability under his accounting method as an indication of the termination of the liability. In this example, the liability was also reversed by the taxpayer and brought into income in a subsequent period. So, the question as to whether the state statute fixes the liability did not become an audit issue. According to the ICC, in a contract between a shipper and the railroad, the state where the contract is executed governs the statute of limitations.

Foreign Travel

Since many freight forwarders are involved in making arrangements for international shipments, they require the assistance of foreign freight forwarders or shipper's agents. Most freight forwarders will travel abroad to promote their services and continuing relationships with their foreign counterparts. The travel and entertainment expenses should be carefully scrutinized to determine if personal travel expenses are being deducted for foreign shipper's agents and shareholders.

International Issues

Since many freight forwarders are involved with importing and exporting goods from foreign countries, there is greater potential for international issues to exist. Listed below are a few international issues raised during the examinations. If it appears that potential international issues exist, a Form 2962, Foreign and Domestic Entity International Transaction Report and Referral should be made to the international group.

Issue 1 - Whether a non-permanent resident alien is required to file a tax return?

A foreign freight forwarder may set up a U.S. freight forwarding company to handle the paperwork in the United States instead of relying on an unknown, unrelated company. The individuals who come to the United States to operate the U.S. freight forwarding company may be employees or shareholders of the foreign company. In one instance, these individuals did not file U.S. tax returns. Resident aliens generally are taxed in the same way as U.S. citizens (IRC section 871). IRC section 7701(b)(1)(a) describes who is considered a resident alien, using three tests (subject to certain exceptions):

1. Lawfully admitted for permanent residence. Individuals who were lawful permanent residents at any time during the calendar year.
2. Substantial presence test. If the individual is present in the United States at least 31 days during the year, and the sum of the number of days he or she was present during the current year and preceding 2 calendar years, when multiplied by the applicable multiplier (1 for current year, 1/3 for the first preceding year, and 1/6 for the second preceding year) equals or exceeds 183 days.
3. Election by the individual to be treated as a resident alien subject to U.S. taxation, subject to any exceptions and rules.

Taxpayer's Position: Arguments were made that since these individuals were not permanent resident aliens, they were not subject to U.S. tax laws. The shareholders of the U.S. freight forwarder did not file U.S. income tax returns since they did not receive a salary from the corporation. Instead of receiving a salary, their personal living expenses were paid by the corporation. By inspecting cancelled checks signed by the shareholders and analyzing credit card transactions, it was determined the shareholders maintained a substantial presence in the United States.

Conclusion: Non-permanent resident aliens are required to file individual income tax returns for the years in which income from the domestic corporation was received. If the individual fails to file the returns with the examining agent, then substitute for return procedures should be followed.

Issue #2 - Whether the transportation tax under IRC section 887 is applicable?

Law: IRC section 887(a), imposes a tax equal to 4 percent of the U.S. source gross transportation income of a nonresident alien or foreign corporation. The term "United States source gross transportation income" is defined under IRC section 863(c)(3) as income derived from, or in connection with (1) the use (or hiring or leasing for use) of a vessel or aircraft, or (2) the performance of services directly related to the use of a vessel or aircraft; including any container used in connection with a vessel or aircraft.

In general, 50 percent of transportation income attributable to transportation which either begins or ends in the United States shall be treated as from sources in the United States. If the transportation begins and ends in the United States, all income shall be treated as derived from sources within the United States.

Trade Associations

International Air Transport Association (IATA). This organization governs and standardizes the industry of air freight forwarding. They establish the maximum standard air freight rates and set minimum financial standards and reporting. Membership is not mandatory but helpful.

Trade Publications

Air Cargo World. This magazine is for airlines, air freight forwarders and consolidators.

CUSTOMHOUSE BROKERS

The customhouse broker works for the importer to gain the release of goods from U.S. Customs. The custom house broker will determine the duties payable to U.S. Customs and arrange for the transportation of goods from the ocean or airfreight carrier to the importer (consignee). Customhouse brokers are governed by Title 19 of the Code of Federal Regulations and the Tariff Act of 1930. The customs duty tariffs are contained in the Harmonized Tariff of the U.S.A. A customhouse broker may also be a consolidator or freight forwarder. But a consolidator or freight forwarder cannot be a customhouse broker without meeting the licensing requirements of U.S. Customs.

Licensing Requirements

A customhouse broker's license is issued by the Secretary of the Treasury to an individual that passes the Custom Broker's Examination which is administered by U.S. Customs or the Foreign Trade Association. The applicant must be a U.S. citizen and have a knowledge of U.S. Customs and related laws, regulations and procedures, bookkeeping, accounting, and other appropriate matters.

The customhouse broker must obtain a permit to operate from the Broker Compliance Office in the district office of U.S. Customs. The permit is issued to an individual, if business is conducted as a sole proprietor; a general partner of the partnership; or a corporate officer of the corporation.

Income

Each customhouse broker has its own fee schedule. A customhouse broker is engaged by the importer of the goods to prepare release documents for U.S. Customs. The fees charged for this service are based on the type of transaction entry (formal or informal), the number of documents it has to prepare, and other transportation services it provides upon release of the goods.

Transactional Analysis

The importer will send the following documents to the customhouse broker:

1. Commercial Invoice.
2. Packing Slip.
3. Bill of Lading.

From these documents, the customhouse broker can determine the type of goods shipped, quantity of goods imported, and whether the entry is informal or formal. An informal entry is one in which the transaction value of the goods in U.S. currency is less than \$1,250. A formal entry is one in which the transaction value of the goods in U.S. currency is greater than \$1,250.

The type of entry will determine which of the following forms need to be filed:

Form 7501 - Entry Summary. This is used to report duties to U.S. Customs (formal or informal entries).

Form 3461 - Entry Immediate Delivery. This is the preliminary 7501 and used in obtaining Customs' release for informal entries.

In the preparation of the release documents, the customhouse broker is responsible for:

1. Checking proper classification of the goods.
2. Determining the origin of the goods (point of origins).
3. Determining the transaction value of the goods and the valuation of the currency. Transactions reflected in a foreign currency are converted into U.S. dollars using the U.S. Customs conversion rate.
4. Checking quota restrictions (limits on certain types of goods, or goods from certain countries).

Once these items have been determined, the custom duty is based on the tariffs contained in the Harmonized Tariff Act of the U.S.A. The tariff is calculated on the type (classification) of goods and the quantity of the goods imported.

While the goods are clearing customs, actual possession of the goods is retained by the airline or steamship company. Generally, a container will not be cleared from U.S. Customs unless all shipments in that container are cleared. However, if the goods are transferred to a bonded customs warehouse or container freight station (CFS), then a single shipment can be released as it clears customs.

To expedite the filing of the Form 7501 and payment of the customs duties, the customhouse broker has the option of using the Automated Commercial System (ACS) or using the old system which requires the writing of a manual check and the delivery of the check and the Form 7501. The Automated Broker Interface (ABI) allows the filings to take place electronically and for the broker to pay the duties by check or by electronic transfer. The automated manifest system (AMS) serves as a merchandise inventory and electronic cargo release system through the electronic exchange of information between U.S. Customs and the importing carriers.

In addition to the customs duties, the customhouse broker may also be responsible for arranging the delivery of the freight; providing customs bonds for

the insurance of cargo duties or payments to U.S. Customs; and obtaining a release from other agencies such as:

<u>Agency</u>	<u>Abbreviations</u>
Food and Drug Administration	(FDA)
Bureau of Alcohol, Tobacco and Firearms	(BATF)
Drug Enforcement Agency	(DEA)
Fish and Wildlife Service	(FWS)
Department of Transportation	(DOT)
Department of Agriculture	(DOA)
Environmental Protection Agency	(EPA)
Federal Communications Commission	(FCC)
Department of Defense	(DOD)

The customhouse broker will charge additional processing fees for each document it prepares to satisfy these other agencies and to facilitate release of the imported goods.

The invoice to the importer consists of the following charges:

1. Ocean or air freight charges.
2. Terminal charges.
3. Entry service fee.
4. Additional invoicing fees (optional).
5. U.S. Customs duties.
6. U.S. Customs user fee.

A customhouse broker is considered to be a "third-party recordkeeper" and the U.S. Customs Service requires that certain records be kept for 5 years from the date of entry.

On a limited basis, U.S. Customs agents will inspect the goods to determine whether they have been properly classified. They perform audits of the paperwork to determine whether the transactions are properly documented and that the duties are timely paid.

Expenses

There were no unusual expenses noted during the examination of the customhouse broker. Most of the expenses incurred were direct costs of operation, such as labor, office supplies, messenger services, and utilities.

Insurance

Due to the extent of responsibility assumed, the customhouse broker may have malpractice insurance or an "errors and omissions" clause included in their liability insurance policy to cover them in the event of any lawsuits arising from the misclassification, valuation, or clearance of goods from U.S. Customs. They also carry insurance to cover loss or damage to the goods upon shipment to the importer.

Penalties

If payment of the customs duties are not timely made or the goods have not been properly classified, certain penalties are applicable. These penalties are called "liquidated damages" and under IRC section 162(f) would not be deductible.

Trade Publications

Air Cargo World (for air freight forwarders).

American Shipper International for shippers, brokers and forwarders).

Daily Commerce News (for motor carriers, freight forwarders, and customhouse brokers).

Global Trade Talk (U.S. Customs service journal for the international trade community).

Trade Associations

Air Transport Association.

Foreign Trade Association.

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Chapter 5

EMPLOYMENT TAXES

GENERAL

The major issue the agent faces during the audit of a trucking company is whether the independent contractor is, in fact, an employee. There is no standard approach or easy way to make this determination since the agent's success in pursuing this issue depends heavily on the development of the facts and circumstances in each case. Failure to raise the issue can provide a safe haven for taxpayers in the event of a subsequent audit.

Note: This may also be an issue on the subhauler's or independent contractor's income tax return.

Employee or Independent Contractor

In evaluating the independent contractor vs. employee issue, the major consideration is whether the independent contractor is an employee under the 20 common law factors. The common law factors for determining employee vs. independent contractor status have a variety of consequences. Therefore, the common law employee vs. independent contractor determination should not be skipped on the theory that it is irrelevant because Section 530 of the Revenue Act of 1978, 1978-3 (Vol.1) C.B. 119, may treat the affected individual as an independent contractor. Such treatment by Section 530 is relevant for purposes of the trucking company's employment tax liability, but does not determine whether the affected individual is an employee instead of an independent contractor for a variety of other purposes.

If, for any period, a taxpayer did not treat an individual as an employee for purposes of employment taxes imposed by subtitle C of the Code, Section 530 deems the individual not to be an employee for that period for purposes of such employment taxes, unless the taxpayer had no reasonable basis for not treating the individual as an employee. The importance of ascertaining employee status goes beyond the mere application of Section 530 relief for the benefit of the trucking company. Both the statute and the legislative history reveal that Section 530 does not change in any way the status, liabilities, and rights

of an individual whose employment status is at issue. The determination of employee status is relevant for a variety of Federal and state liabilities.

Determination of employee vs. independent contractor status is relevant with respect to the following Federal tax issues: (1) whether an individual is liable for the employee's own share of the FICA tax, (2) whether business expenses must be itemized and are subject to the 2 per cent floor on miscellaneous itemized deductions of IRC section 67, or are subject to the adjusted gross income additions of IRC section 62(c) and the itemized deduction limitation of IRC section 68; (3) whether the trucking company's qualified pension plan must treat the individual as an employee for qualification purposes; and (4) whether the individual has continuing health care coverage after termination for purposes of COBRA (Consolidated Omnibus Budget Reconciliation Act of 1986, P.L. 99-272). In addition, employee status is also relevant for purposes of determining coverage under or liability for workmen's compensation benefits, Federal and state civil rights laws, the Fair Labor Standards Act (regulating minimum wages and overtime pay), the National Labor Relations Act (providing employees with the right of collective bargaining), the Occupational Safety and Health Act (regulating safety in the work place), and the Americans with Disabilities Act (requiring employers to make special accommodations for disabled employees).

After evaluating the employee vs. independent contractor issue under the 20 common law factors, determine whether any of the safe harbor provisions of Section 530 of the Revenue Act of 1978 apply as a defense. A reasonable basis will be deemed to exist if the taxpayer acted with reasonable reliance on any of the following:

1. Judicial precedent, published rulings, technical advice with respect to the taxpayer, a private letter ruling to the taxpayer, or IRC section 530(a)(2).
2. Past Internal Revenue Service audit of the taxpayer in which there was no assessment attributable to the treatment (for employment tax purposes) of individuals holding positions substantially similar to the position held by the individual whose status is at issue.
3. Long-standing recognized practice of a significant segment of the industry in which such individual

was engaged. The industry practice defense can be raised only within the sphere of competition for the area (such as, coast to coast drivers within a region).

If a taxpayer should fail to meet the above safe haven provisions, they may be entitled to relief if they can demonstrate, in some other manner, a reasonable basis for not treating the individuals as an employee. The safe haven relief as allowed by this section will only apply if the following criteria have been met:

1. All required federal tax returns (including information returns) are filed by the taxpayer on a basis consistent with the taxpayer's treatment of the individual as not being an employee (such as, Forms 1099 filed), and
2. The treatment is consistent for periods beginning after December 31, 1977.

Rev. Proc. 85-18 amplifies and supersedes Rev. Proc. 81-43, 1981-2 C.B. 616, which provides instructions for implementing the provisions of Section 530 of the Revenue Act of 1978. Rev. Proc. 85-18 reflects changes made to Section 530 of the Act by Section 269© of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, 1982-2 C.B. 462, 536.

According to Rev. Rul. 81-224, 1981-2 C.B. 1973, relief under Section 530(a)(1) of the Act will not be granted if a Form 1099 or other appropriate information returns have not been timely filed for each worker for any period after December 31, 1978.

IRM Exhibit 4640-3 provides a flowchart to determine whether the relief provisions under Section 530 are available to the taxpayer.

Classification as an Employee

An individual who works as a truck driver may be classified:

1. As a statutory employee under IRC section 3121(d)(4)(A), the individual will be classified as an employee if he or she performs services for remuneration as an agent-driver or commission-driver engaged in distributing meat products, vegetables products, fruit products, bakery products, beverages (other than milk), or laundry or dry-cleaning services, for his or her principal.

2. As an employee under the common law rules. Treas. Reg. section 31.3401(c)-1 states that the relationship of employer and employee exists when the person for whom the services are performed has the right to control and direct the individual who performs the service not only as to the result to be accomplished by the work but also as to the details and means by which the result is accomplished.

COMMON LAW FACTORS

Rev. Rul. 87-41, 1987-1 C.B. 296, details the 20 common law factors and provides guidelines for determining employee or independent contractor status relating to technical service personnel under IRC section 1706. At this time, there is no revenue ruling that addresses the 20 common law factors as they relate to rulings in Exhibit 5-1. The 20 common law factors can be adapted to the independent truck drivers as follows:

1. Is there a significant investment in equipment? If the drivers own their transportation equipment, then they are free to render services to others.
2. Who determines the route? How much control is exerted over the manner in which the independent contractor handles the deliveries?
3. How is the independent contractor able to realize a profit or incur a loss? Who has liability for loss or damage to goods?
4. Are services rendered to different firms? If yes, this would indicate they are an independent contractor.
5. Does the employer have the right to terminate or discharge the driver without liability? An independent cannot be fired if the terms of the contract are met.
6. Can the driver terminate without liability? If yes, this would indicate an employer/employee relationship. An independent contractor can be held liable to complete a specific job.
7. Are the services provided by the independent contractor integrated in the business? (For example, the distribution of goods or services of the business).

8. Does the independent contractor pay for operating expenses by reimbursing the company or paying them directly? If no, then this may indicate that they are an employee.
9. Is the worker provided with tools and materials? If the driver/helper operates the employer's equipment such as tractors, forklifts, etc., this would be an indication that they are an employee.
10. Does the driver have the basic training to drive a truck and a license to operate a tractor and trailer? Most drivers will have the basic training. However, if the driver has to be trained to operate additional equipment other than the equipment owned, then he or she may be an employee.
11. Must the driver personally render services? The driver not having the ability to hire someone else to drive the truck indicates that he or she may be an employee.
12. Must the driver comply with written instructions and attend meetings? If yes, then this indicates the amount of control exerted over the drivers.
13. Are there preset work hours?
14. Must the driver devote full time to business? If yes, this indicates a restriction placed on the earning potential of the independent.
15. Is the work performed on employer's premises? If yes, they may be employees. However, by the nature of the work, drivers do not usually work on the employer's premises.
16. How is payment for services handled? Is the driver paid at the end of a specific job or on a regular basis such as a set rate per hour or week? Hourly rates and fixed salaries tend to indicate the driver is an employee.
17. Does the driver have to submit oral or written reports? Most drivers are required to complete a manifest sheet showing daily deliveries and provide proof of delivery.
18. Can the driver hire or fire assistants? If no, this indicates they are not in control of their operations but are directed by an employer.

19. Does the driver offer services to public? Does the driver have the proper operating authority?
20. Is the working relationship continuous? If yes, this may indicate they are an employee.

Porthaulers

An area of concern for the Service has been the treatment of porthaulers. Porthaulers are part of the "landbridge" operation in transporting goods from the harbor to an inland destination. To haul freight out of the harbor, the porthauler must present a CHL card (customhouse license). The license is obtained by the employing company and not the porthauler. The port haulers will represent themselves to be employees of the company when they apply for the Cartmen/Lightermen Identification Card (Customs Form 3873) from U.S. Customs. The U.S. Customs Service considers this to be a violation of Chapter 1, Part 112 of the U.S. Customs Service Code, since the CHL was obtained through a misstatement of material fact. The company represents to U.S. Customs that drivers are employees of the corporation when they are paid as independent contractors.

Consistent treatment of the issue has been a concern to the Service. At this time, there is no revenue ruling or revenue procedure which clearly defines the status of the porthauler or truck driver. Using the 20 common law factors and taking the safe haven relief provision of Section 530 into consideration, the agent must make his or her own subjective determination. This may yield different conclusions depending on the facts and circumstances of each case.

Casual Labor

At times, the defense has been raised that drivers hired were casual labor. Under Treas. Reg. section 31.3401(a), casual labor refers to payments made not in connection with a trade or business. Under IRC section 6045I, if more than \$600 is paid to one individual during the calendar year, they are required to report this amount on a Form 1099. Failure to file an information return does not provide the employer the safe harbor relief provisions of Section 530 of the Revenue Act of 1978.

Subhaulers should be classified as independent contractors, subject to the filing of information returns under IRC section 6041A, or as employees under IRC sections 3121(d) and 3401(c), subject to FICA and FIT withholding.

Since each case must stand on its own, the 20 common law factors should be used to develop the facts and circumstances in determining whether the independent contractor(s) should be an employee(s). By applying each of the 20 common law factors, employers have been convinced that independent contractors should be classified as employees.

Audit Techniques

Although there can be no standard approach in making the determination, certain steps can be recommended for gathering the facts needed to make such a determination.

1. Interview the shareholder to find out as much information about the types of drivers employed (20 common law factors), use of subhaulers, helpers, ownership of equipment, control exercised over the subhaulers, routes driven, preset working hours, and regular payment intervals.
2. Review the driver or subhauler records (such as the subhauler agreement, the trip settlement statements, or driver manifests); Forms 1099 and W-2; and other pertinent accounting records for common carriers to corroborate or contradict information received during the initial interview.
3. Apply the 20 common law factors to establish employee vs. independent contractor status.
4. Mail the SS-8 or Questionnaire to the subhaulers or independent contractors. This will provide an indication of how the individuals classify themselves.

The following IRM citations will help in preparing the examination reports.

- IRM 4640 - Employment Tax Examination Procedures.
- IRM Exhibit 4640-1 - Employer-Employee Relationship (20 Common Law Factors).
- IRM Exhibit 4640-2 - Statutory Employees.
- IRM Exhibit 4640-3 - Section 530 Flowchart.

- IRM 4650 - Preparation of Employment Tax Reports.

For additional assistance in developing the issue, the report preparation, or to make a referral, contact an employment tax specialist.

Other Employment Tax Adjustments

Employment tax adjustments have been made for payments to helpers (loaders or lumpers), other outside labor payments such as office help, part-time workers, and the payment of bonuses and pensions. Additional FICA under IRC sections 3101 (employee) and 3111 (employer) and FUTA under IRC section 3301 have been assessed. Under Treas. Reg. section 31.3402(g)-1(a)(2)(ii) for supplemental wages, the FIT withholding rate is 20 percent.

Under IRC section 3509, the taxpayer is allowed some relief by applying reduced FICA rates to the independent contractors (drivers, helpers, etc.) converted to employee status.

If the taxpayer has filed Form 1099, under IRC section 3509(a) the rate for FICA is 1.53 percent (20 percent x 7.65 percent) which is 20 percent of the employee's FICA rate and 7.65 percent which is 100 percent of the employer's FICA rate for a total FICA tax withholding rate of 9.18 percent for 1993. The FIT withholding rate is 1.5 percent of the gross amount paid.

However, if the taxpayer failed to file Form 1099 for the independent contractors, then the rate under IRC section 3509(b) for FICA is 3.06 percent (40 percent x 7.65 percent) which is 40 percent of the employee's FICA rate and 7.65 percent which is 100 percent of the employer's FICA rate for a total FICA withholding rate of 10.71 percent for 1993. The FIT withholding rate is 3.0 percent of the gross amount paid.

COURT CASES AND REVENUE RULINGS

INDEPENDENT CONTRACTORS

The most significant court cases and revenue rulings in which the truck drivers were held to be independent contractors have been summarized below.

Rev. Rul. 76-226, 1976-1 C.B. 322

Truck owner-operators, engaged under contract by an interstate trucking company, who provide their own equipment, maintenance, drivers, and generally maintain a facility for servicing their equipment, select their own routes, are paid a percentage of the contracting company's receipts for the shipment, and pay their own licensing fees, road use taxes, and all operating expenses are not employees of the company.

United States v. Mutual Trucking, 141 F.2d 655 (6th Cir. 1944)

Truck owner-operators engaged in hauling exclusively for appellee at a flat rate for each trip under contracts which expressly provide that such operators shall not be considered employees of appellee were held to be independent contractors where they used their own equipment, hired and discharged their drivers, and paid the wages of the drivers and the costs of operating their trucks. Neither the drivers nor the owner-operators were under appellee's control with reference to the manner of their work. It was significant that the appellee usually did not know in advance what particular driver was to take the freight. The cogent evidence upon the proposition that while the appellee instructed the owner-operators when and where to transport the freight carried, it did not instruct them how to transport it.

United States v. Silk, Harrison v. Greyvan Lines, Inc., 67 S. Ct. 1463

In *United States v. Silk*, workers, who unloaded coal at an agreed price per ton, with no opportunity for gain or loss except from the work of their hands and picks and shovels, and who were subject to all necessary supervision by a coal retailer, were "employees" within the meaning of the Social Security Act, but driver-owners of trucks who hired their own helpers, did not always haul for a single business, and had considerable responsibility for investment and management, were "independent contractors" not within the act. Driver-owners were paid on a per load basis.

The appellate court determined that "where the arrangements leave the driver-owners so much responsibility for investment and management as here, they must be held to be independent contractors."

Bulovinsky v. Gardner, DC, W. Dist. of Pa., 286 F. Supp, 688 (1968)

The claimant drove a tractor-trailer, which he owned and maintained at his own expense, for a trucking company under a lease agreement, receiving a percentage of the gross revenue earned by the leased equipment, part of which was paid to him in the form of a driver's check and the balance for equipment rental. However, his gross income from the lease of his equipment was greater than his earnings from driving. While there was some conflict in the evidence, the court found that on the pivotal question of the extent to which the company reserved the right to control the manner or method of claimant's work, he presented insufficient evidence to warrant reversal of the Secretary's finding that under the criteria set forth in *United States v. Silk and Greyvan Lines, Inc.*, claimant's relationship with the trucking company was that of independent contractor, and not employee.

Rev. Rul. 55-593, 1955-2 C.B. 610

Owners-drivers and drivers of rented trucks who contract to deliver merchandise for a company at specified rates, receive no payment for articles not delivered and pay all their operating expenses including insurance coverage, are not employees of the company. The drivers are independent contractors and are employers of any individuals engaged by them to assist in carrying out the terms of the contract.

EMPLOYEES

The most significant court cases and revenue rulings in which truck drivers and helpers were held to be employees have been summarized below.

MAV Freight Service, Inc. v. United States (1978, D.C., NY)
A.F.T.R.2d 78-5821, 78-2 U.S.T.C. 9707

Unloading helpers employed by a trucking firm who were hired by the employer's drivers and who were under their control, worked fairly regularly for the same trucker, were unskilled, and had no substantial investment in tools, and were paid by weekly checks.

Smith, Richard v. United States, (1978 CA5) A.F.T.R.2d 76-756,
78-1 U.S.T.C. 9263

Moving van drivers who were hired by a van owner as long distance drivers, were employees rather than independent contractors, since the taxpayer had the right to control the manner in which the drivers performed their work, even though they designated their own routes and work schedules. Also, the drivers had a very small investment in tools and equipment, compared to the taxpayer's large investment in the two trucks.

Rev. Rul, 72-467, 1972-2 C.B. 539

A truck driver performing services for an airline company under a contract referring to him as an independent contractor but who is subject to the direction and control of the company, is an employee of the company.

Rev. Rul. 71-524, 1971-2 C.B. 346

Truck driver of a truck company leasing tractor-trailer rigs with a driver to a contract carrier and retaining the right to direct and control the driver to the extent necessary to protect its investment is an employee of the trucking company.

Rev. Rul. 70-441, 1970-2 C.B. 210

Where truck operators under a lease agreement were required to use specified routes and register at stations on the routes. The lease stated that the owners and operators of the trucks "were directly in the employ of and answerable to the company." The trucks bore the name of the lessor company. The truck owners and substitute drivers were engaged by the owners with the express consent of the company were held to be employees of the company even though they were paid on a mileage and tonnage basis.

Rev. Rul. 70-602, 1970-2 C.B. 225

Truck owner-operators and their assistant drivers performing delivery services on a temporary basis for a company that has the right to direct and control the manner in which their services are performed are employees of the company.

Rev. Rul. 69-349, 1969-1 C.B. 261

Truck owner-driver and his substitute driver who perform delivery services during regular working hours each day for a company that exercises control as to details and manner of performance of the services are employees of the company.

Rev. Rul. 68-583, 1968-2 C.B. 459

A truck driver was engaged by a firm doing aerial crop dusting and spraying for third parties, to perform services, when the weather permitted, 7 days a week. The services consisted of driving the firm's truck containing chemicals to a suitable airplane landing point near the area to be dusted; mixing and loading the chemicals on the airplane; measuring the width of each swath; acting as a foreman in directing farmers and their employees serving as flagmen; and under the firm's supervision, performing other services necessary to the dusting and spraying activities. The driver performed the services personally, did not furnish any equipment, and did not perform services for others on the days he worked for the firm. The driver was an employee of the firm, regardless of the fact that he was sometimes designated as a partner or coadventurer.

Rev. Rul. 58-46, 1958-1, C.B. 347

An individual is exclusively engaged by a company to operate its delivery trucks, is paid by the company the full amount of the delivery charges collected from the customers, must repay the company the purchase price of the trucks, provide adequate maintenance and insurance coverage, and provide and pay for all helpers. The company retains full control and legal ownership of the trucking equipment. The operator and any helpers engaged to assist him are employees of the company.

Rev. Rul. 55-543, 1955-2 C.B. 400

The employee-drivers of a motor freight line company engage local union helpers to unload "drop" freight shipments at points which do not have terminal facilities. The employee-drivers pay such helpers but are subsequently repaid by the company. The helpers are employees of the company.

Rev. Rul. 54-555, 1954-2 C.B. 339

Drivers for the truck owner who furnished pick-up and delivery for a cleaning and laundry service are employees.

Grand Rapids Gravel Co. v. United States, DC. Mich., W. Dist. S Div., 3/30/43

Truck owner-drivers engaged in hauling sand and gravel for a company were employees for employment tax purposes, and not independent contractors, where the company had the right to discharge them at will and without liability for doing so, and the amount of work performed by each owner-driver was wholly within the discretion of the company. The fact the drivers owned their own trucks and they were paid for hauling on a yardage basis was insufficient to outweigh the conclusion they were employees.

Matter of Hiner, Bankrupt, DC. Ind., S. Dist. Indianapolis Div.,
9/2/41

Truck owner-drivers were employees, rather than independent contractors, where the bankrupt company for which they had performed services had the right to control, direct, and discharge them, and where the drivers were not free to render services to others.

Matter of Barbour Transportation Co., Debtor, DC, Okla. W. Dist,
4/30/47

An individual who did not own a truck, but operated one for a company under a contract that provided him with an opportunity to become the owner, was an employee of the company, and not an independent contractor, where the contract was not for any definite or fixed term, and gave the company either complete or considerable control over the method and manner in which the trucking services were to be performed.

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Chapter 6

EXCISE TAXES

INTRODUCTION

As part of the package audit requirements, the agent will need to be aware of the filing requirements for the following excise tax returns.

HEAVY VEHICLE USE TAX (FORM 2290)

The Heavy Vehicle Use Tax is filed annually for the period covering July 1 through June 30. The due date for filing the return is August 30. An agent will encounter this excise tax return more often than the other excise tax returns because this one is required for all vehicles used on public highways. The maximum annual tax is \$550 per vehicle over 75,000 lbs. The registered owner is liable for the tax and must show proof of filing the Form 2290 when the vehicle is registered with the DMV. However, the registered owner may be able to file exempt if the vehicle is driven 5,000 miles or less (7,500 miles or less for agricultural vehicles), or its taxable gross weight (laden weight) is less than 55,000 pounds.

Taxable gross weight is defined under IRC section 4482 as the sum of:

1. The actual unloaded weight of the vehicle fully equipped for service.

plus

2. The actual unloaded weight of any trailer or semitrailer that is customarily used in combination with the vehicle. However, if the vehicle is registered in a state that requires a declaration of gross weight stated as a specific amount, the taxable gross weight used to figure the tax must be no less than the declared gross weight

plus

3. The weight of the maximum load customarily carried on the vehicle and on any trailer or semitrailer customarily used in combination with the vehicle.

The tax is calculated on the taxable gross weight of the vehicle using the categories and rates found on the Form 2290. If any additional vehicles subject to the tax are placed in service during the year, another Form 2290 should be filed. It is due by the last day of the month after the month the vehicle is first used on the public highways.

Also, if after Form 2290 is filed, the taxable gross weight of the vehicle is increased so that the vehicle falls within a new category, a new Form 2290 must be filed and additional tax paid.

The most common errors on the Form 2290 are:

1. Miscategorization - wrong taxable weight category.
2. Omissions - not all vehicles owned are claimed.
3. Prorations - vehicle not in use at the time the return is due.
4. "Exempt" status.

If the taxpayer fails to file, and the determination is made that the tax is due, delinquent returns should be filed. For more information, refer to IRC section 4481 and Publication 349 - Federal Highway Use Tax on Heavy Vehicles or contact the Excise Tax Group for assistance.

Audit Techniques

In determining whether the trucking company and/or the owner-operator is required to file (or has filed properly) the Form 2290, the agent may want to follow these suggested audit procedures:

1. Determine whether the Form 2290 was filed:
 - a. Request a copy of the Form 2290 filed with the Internal Revenue Service.
 - b. Secure a transcript of the account on IDRS using MFT 60, with the month-end XX01 (for example, 8906).
 - c. Contact an excise tax agent to check their list of filings (alpha or EIN).

Note: The taxpayer is required to obtain an EIN for the filing of the Form 2290. A Social Security Number (SSN) is not acceptable.

2. Determine if they are liable for the tax:
 - a. What kind of equipment does the taxpayer own (3-axle tractor, yardgoat, trailers)?
 - 1) Depreciation schedules.
 - 2) Lease agreement with equipment schedules.
 - 3) DMV registrations.
 - 4) Insurance policies with asset schedules.
 - 5) Personal property tax schedules.
 - b. What type of cargo is being hauled? Cargo descriptions can be obtained by inspecting the bills of lading or billing invoices. The bill of lading/invoice will also indicate origination and destinations of the shipments.
 - 1) Type of shipments (truck loads, less than truck loads).
 - 2) Type of goods (auto body parts, tires, home electronics, canned goods).

Auto body parts and home electronics are relatively light because of the large amount of protective packing included with the shipments. However, small machine parts, canned goods, and tires are more dense and heavy. For example, the total laden weight of automobile and truck tires (excluding the vehicle weight) is approximately 50,000 lbs.
3. Determine whether the amount of the tax is correct.
 - a. Was Form 2290 filed "exempt"?
 - b. Does the taxable gross weight (laden weight) exceed the 55,000 weight limitation?

Example 1

A 3-axle tractor, chassis, and 40 foot container (empty) might weigh a total of 29,610 lbs - the tractor weighing 16,500 lbs. and the container and chassis combined weighing 13,110 lbs. Using an average of 30,000 lbs. for a 3-axle tractor, chassis, and

empty container, it would only take 25,000 lbs. of freight to make the registered owner liable for the tax. Generally, a two-axle vehicle will not exceed the 55,000 lbs. of total laden weight requirement.

c. Test the total gross weight.

Show up at the business (perhaps on payday) and ask to have driver(s) or independent(s) drive over the weightmaster to verify total gross weight.

d. Review traffic citations.

Most trucking companies and/or independents will claim they transport less weight than their equipment is capable of hauling or that their filing status is "exempt." By inspecting traffic citations for overweight violations (such as, weight in excess of 80,000 lbs.), the examiner will have sufficient documentation to support the assessment of the maximum amount of tax.

If the trucking company hires the services of independent contractors, the agent may want to expand the examination to verify that they filed Form 2290 properly. Particularly if there are indications, they might be exceeding the minimum weight limitation, such as owning a 3-axle tractor, transporting heavy loads, or traffic citations.

Once the determination is made, an adjustment or assessment of additional taxes may be required, a referral or request for assistance should be made to the excise tax group.

QUARTERLY FEDERAL EXCISE TAX (FORM 720)

For quarters beginning after December 31, 1990, the due date of the return is the last day of the first month following the end of the quarter.

<u>Quarter Covering</u>	<u>Due Date</u>
January, February, March	April 30
April, May, June	July 31
July, August, September	October 31
October, November, December	January 31

Prior to December 31, 1990, the due date was the 10th day after the last day of the first month following the end of the quarter, if deposits of tax were timely made.

<u>Quarter Covering</u>	<u>Due Date</u>
January, February, March	May 10
April, May, June	August 10
July, August, September	November 10
October, November, December	February 10

The quarterly Federal excise tax returns are filed for: Environmental Taxes, Air Transportation and Communications Taxes, Fuel Taxes, Leaking Underground Storage Tank (LUST) Taxes, Manufacturers Taxes, Retail Taxes, and Other Excise Taxes.

During the examination of a trucking company, the agent needs to be aware of the retail tax on heavy trucks, trailers and tractors, and the fuel taxes. For exemptions and definitions, see Publication 510 on excise taxes.

Fuel Tax

Prior to April 1, 1988, the diesel and special motor fuel tax could be paid by the ultimate user of the fuel, for example, a trucking company. Many trucking companies have underground fuel tanks located on the premises to be used by company drivers and owner operators. Since the fuel tanks could be used by the company drivers and the owner-operators, this fuel tax would be paid by the trucking company based upon the number of gallons of fuel put into the fuel supply tank of their vehicles.

Owner-operators would have the charge for the fuel and the fuel tax deducted from their gross earnings. Although the owner-operator would have also shown a deduction for the fuel tax, they probably would not have been required to file a Form 720 since the liability for the tax is on the person making the taxable sale of the fuel.

As of April 1, 1988, the diesel tax generally became the liability of the wholesaler rather than the retailer. Now, the excise tax is applicable only if the fuel is purchased free of any federal gasoline taxes and Form 637 has been filed with the Internal Revenue Service claiming an exemption.

Audit Technique

A trucker can buy diesel fuel tax free under the procedures of notice 88-132, 1988-2 C.B. 552, if the trucker intends to use the fuel in an off highway use such as in an engine that is not the propulsion engine of the vehicle. However, if a trucker buys diesel fuel tax free under these procedures and then uses it as a fuel in a diesel-powered highway vehicle, then the trucker is liable for the diesel fuel tax. See IRC sections 4041(a)(1) and 4092 (b)(1)(C).

Retail Taxes

A retail tax of 12 percent of the sales price is imposed on the seller for the first retail sale after the manufacture, production, or importation of heavy trucks, trailers, and tractors. The tax is imposed on the following articles including related parts and accessories (sold on or in connection with, or with the sale of the article):

1. Truck chassis and bodies.
2. Truck trailer and semi-trailer chassis and bodies.
3. Tractor of the kind chiefly used for highway transportation in combination with trailer or semi-trailer.

Many times, a company will choose not to buy a new tractor or trailer, but instead they will refurbish their old equipment. Using the old chassis, axles, engine and transmission, a "glider kit" containing the necessary parts and accessories to rebuild a new cab, instrumentation, and interiors can be purchased to complete the tractor. Under such circumstances, the owner may be subject to the retail tax on its use of the vehicle. See Rev. Rul. 91-27, 1991-1 C.B. 192.

Audit Techniques

During the examination of the capital assets account, the agent should inspect the invoices for the heavy trucks, trailers, and tractors to verify that the 12 percent retail tax was included in the sales price.

Also repairs or expenses incurred in the remanufacture a vehicle may be subject to excise tax. Since the parts and accessories by themselves may not be subject to the excise tax, the purchaser of the parts may be liable for the excise tax if the parts and accessories are used to remanufacture a vehicle or if they are

installed on a new vehicle within 6 months of the date on which the vehicle is placed in service. For depreciation purposes, the total amount to be capitalized includes the cost of the glider kit, the excise tax, the cost of any parts used to complete the glider kit, plus the labor to put the kit together.

For example, a corporation may acquire hoists for all of its vehicles. If the price of the parts and accessories, including the installation, is \$200 or more, and the parts are installed within 6 months after the vehicle is placed in service; they also would be subject to the excise tax. If the corporation or related entities own a fleet of vehicles and they are replacing or refurbishing the entire fleet, this may result in a substantial amount of excise tax being due.

OTHER EXCISE TAXES

Generally, Form 720 is not filed by a trucking company unless it purchased glider kits or used its own tax free supply of diesel fuel. There are, however, other excise taxes the agent might want to be aware of during the examination of a freight forwarder. For example, the premiums paid for certain insurance policies issued by foreign insurers may be subject to an excise tax. The rate of the tax is applied to each dollar of the premium payment as follows:

1. Casualty Insurance and indemnity,
fidelity and surety bonds: 4 percent
2. Life, sickness, and accident insurance,
and annuity contracts: 1 percent
3. Reinsurance policies covering any of
the above contracts: 1 percent

The liability for the excise tax is that of the person making the payment of the premium to the foreign insurer or the person's agent. IRC section 4372(a) defines the term "foreign insurer" as an insurer who is a nonresident alien individual, a foreign partnership, or foreign corporation.

A U.S. freight forwarder may be liable for the excise tax under IRC section 4371 on insurance premiums paid to the foreign insurance carrier for each insurance policy written for a party qualifying as an insured under IRC section 4372(d).

Under IRC section 4372(d), the term "insured" includes a domestic corporation or partnership, or individual resident of the United States, that is insured against or with respect to hazards, risks, losses, liabilities wholly or partly within the United States. The term also includes a foreign corporation, foreign partnership, or nonresident individual, engaged in a trade or business within the United States, against or with respect to hazards, risks, losses, or liabilities within the United States.

If a premium paid to a foreign insurance carrier is income of the carrier subject to U.S. income tax, the U.S. freight forwarder is not liable for excise tax on the premium payment. A premium paid to a foreign insurance carrier that is not subject to U.S. income tax may nevertheless be exempt from the insurance excise tax if the foreign insurer is a resident of a country with which the United States has a treaty waiving the excise tax and the insurer meets the requirements under the treaty for entitlement to the exemption.

These premiums are not subject to U.S. taxation under IRC section 881 or to withholding under IRC section 1441 unless the foreign freight forwarding agents are also actively engaged in the international operation of ships or aircraft, and the premiums are in fact compensation for transportation services. Since the foreign freight forwarding agents are not actively engaged in the international operation of ships or aircraft, the income of the foreign agents are not subject to the 4 percent transportation tax under IRC section 887. Again, it is advised that the agent request the assistance from the excise tax group and an international agent in developing the issues and assessing the excise taxes.

Chapter 7

PENALTIES

INFORMATION RETURN PENALTIES

The Revenue Reconciliation Act of 1989 restructured certain information return penalty Code sections to avoid the "stacking" of penalties on returns and statements which contained multiple reporting failures. The revisions applicable to returns filed after December 31, 1989 are as follows.

IRC Section 6721- Failure to File Correct Information Returns

For returns due after December 31, 1989, a penalty of \$50 per return with a maximum limitation of \$250,000 for each calendar year, will be imposed for:

1. Failure to file an information return on or before the required filing date.
2. Any failure to include all of the information required to be shown on a return.
3. The inclusion of incorrect information on a return.

In the case of intentional disregard, the penalty amounts are increased to the greater of \$100 per failure or 10 percent of the aggregate amount of the items required to be reported with no maximum limit.

IRC Section 6722 - Failure to Furnish Correct Payee Statements

A penalty of \$50 with the maximum penalty of \$100,000 is imposed for:

1. Any failure to furnish a payee statement on or before the required due date.
2. Any failure to include all of the information required to be shown on a payee statement or the inclusion of incorrect information.

In the case of intentional disregard, the penalty shall be the greater of: (a) \$100 per failure or (b) 10 percent of the aggregate amount of the items required to be reported correctly. If intentional disregard is found to be applicable, the \$100,000 limitation will not apply.

Information returns are required to be filed by the person for whom the service is performed or the person receiving the cash:

<u>Form</u>	<u>IRC Section</u>
1099-MISC	6041A(a) Remuneration for services.
1099-MISC	6041A(b) Direct Sales of \$5000 or more.
8300	6050I(a) Cash received in a trade or business.

Payee statements required to be issued and subject to the above penalties are:

<u>Form</u>	<u>IRC section</u>
1099-MISC	6041(a) Payments of \$600 or more.
W-2	6051 Receipts for employees.

Note: The penalties under IRC sections 6721 and 6722 are asserted in a separate penalty file.

BACK-UP WITHHOLDING

Another compliance tool is the application of the back-up withholding provisions of IRC Section 3406. This section may be applicable if:

1. A required Form 1099 was not filed.
2. No TIN was requested or was not supplied or the payee (subhauler) fails to furnish his or her TIN to the payor in the manner required.
3. The Secretary notifies the payor that the TIN furnished by the payee is incorrect.

If this occurs, the payor shall deduct and withhold from such payment, a tax equal to 20 percent of the payment. However, if the payor fails to withhold, he or she becomes liable for the tax under IRC section 3406. This assessment can be abated by proving the payee reported the compensation.

This abatement is performed by the Service Center upon receipt of Forms 4669 and 4670 which have to be completed by the individuals and the corporation.

Form 4669 - Employee Wage Statement.

Form 4670 - Request of Relief from Payment of Income Tax Withholding (summary and transmittal).

A reportable payment subject to withholding follows the criteria for information reporting as set forth by IRC section 6041(a). However, the payor can avoid the 20 percent back-up withholding on reportable payments if:

1. The payee was exempt from withholding.
 - a. Corporations.
 - b. Financial institutions.
 - c. Tax-exempt entities.
 - d. Governmental entities.
 - e. International organizations.
2. The payee has satisfied the requirements of IRC section 3406(a)(I).
3. The payment is subject to some other withholding provision.

The key criteria regarding back-up withholding lies in whether the particular independent contractor refused to give the trucking company a TIN. Therefore, inquiries must be made of the trucking company as to what steps were taken and what response was received regarding any requests. If a TIN was provided to the trucking company but was simply left off the Form 1099 by accident or the Form 1099 was not filed by mistake, then the trucking company may not be subject to back-up withholding since the subhauler provided a TIN.

Evidence which tends to support a trucking company's claim that a request was made and complied with would include whether it could currently supply a correct TIN for the individual or provide a copy of the W-9.

An entity is still bound by IRC section 3406 even if it does not request any TIN and therefore is not refused by the payee. Payments are subject to back-up withholding even though the payor fails to request TIN's from the payees.

The penalty under IRC section 3406 is asserted on the Form 941 return's for the applicable quarters of payment. This is similar to the treatment of employment taxes.

Audit Technique

The first step in determining whether back-up withholding should be applied begins during the package audit phase. The agent should secure copies of:

1. The Form 1096 transmittal form and all of the Form 1099 information returns for the calendar years that span the fiscal years being examined.
2. Any schedules used to prepare the Form 1099 statements. This would assist the agent in determining whether the amount on the information return is correct.
3. The W-9 filed for each subhauler.
4. A transcript for the Forms W-9 which had corporate EINs.

Once the Forms 1099 have been obtained, the following procedures can be applied.

Test the Accuracy of Total Amounts on Filed Forms 1099

1. The total number of statements filed per the Form 1096 transmittal should agree with the Form 1099 statements. This reconciliation will verify whether all Form 1099 returns have been provided.
2. Reconcile the subhauler expense per the tax return with the amount filed on the Forms 1099. The amount of the cash disbursements are usually less than the amount to be reported on the Form 1099.
3. To find out whether the taxpayer actually filed the Forms 1096 and 1099, a transcript can be requested by completing Form 6882, IDRS Master File Information Request, requesting a "PMFOL" or a "PATRA."

This transcript provides the information on the Form 1096 as to the number and the total dollar amount of the Forms 1099 filed by the taxpayer. The transcript does not provide information as to which individuals the Forms 1099 were filed.

Test for Unfiled Forms 1099

1. Scan the cash disbursement journals for payments made to individuals whose names did not appear on the Form 1099 statements.

2. Ascertain the reason why the taxpayer did not prepare a Form 1099 statement for those individuals. If the taxpayer claims the individual is a corporation, ask for the documents to support this claim (statement from the subhauler, Form W-9, copy of the state registration certificate).

Test the Accuracy of the Payor's and Payee's Identification Number

1. The Forms 1099 should also be examined for incomplete or inaccurate identifying information. Both the payor's and the payee's complete name, address, and Federal TIN are required.
2. Request transcripts for questionable EIN's and TIN's. There may be instances where the subhauler may represent himself or herself to the trucking company as being a corporation by providing the EIN assigned for filing the Form 2290, Heavy Vehicle Use Tax or the employment tax returns, Forms 940 and 941. Subhaulers organized as sole proprietorships should have social security numbers entered, not an EIN. If the subhauler's TIN is incomplete or missing, consideration should be given to the application of back-up withholding.

Even though the trucking company may not be subject to back-up withholding, the above procedures will assist the agent in determining whether the company is subject to various information return penalties, as previously discussed.

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GLOSSARY

TERMINOLOGY

Backhaul -- Converse of linehaul; movement of freight from point of destination to point of origination. Part of the overall movement of door-to-door service.

Bill of Lading -- Shipping document which transfers title to the goods.

Bobtail -- A two-axle truck with the van permanently attached to the chassis.

Bingo Stamps -- Trip permits issued by the PUC for each intrastate freight move.

Break-bulk Agent -- Breaks down a container into its various shipments; deconsolidator.

Cargo Handler -- Person that loads freight onto dock and into trailers; also known as swampers, lumpers, stevedores, longshoremen.

Carrier -- An ocean vessel, air freight or common carrier in the business of transporting goods or persons.

Cartage -- To transport goods between the freight terminal and cargo carrier.

Chargebacks -- Uncollectible account receivables which reduce the cash received from factored invoices.

Chassis -- Basically a long, thin, steel frame on wheels which attaches to truck tractors to haul containers.

Co-loader -- A freight forwarder that consolidates shipments with another freight forwarder.

Common Carrier -- A for-hire carrier who holds itself out to the public to engage in the transportation of freight at published rates between a group of points which they are authorized to serve.

Consignee -- The company or individual that receives the shipment of freight.

Consolidator -- Purchases container space at a volume price for resale to freight forwarders. Practice of taking several small separate shipments of freight and organizing them into one container.

Container -- A large metal box used to store freight on ocean vessels and rail cars. Once the vessel arrives in port, the container can be loaded onto either a truck chassis or a railroad car. They usually come in 20 or 40 foot lengths.

Container Freight Station (CFS) -- Customs-bonded warehouse.

Contract Carrier -- Firms whose transportation service is limited to individual contracts which are tailored to the specific needs of a shipper or a group of shippers.

Custom Delivery Order -- Delivery order prepared by a customs house broker.

Customs House Broker -- A licensed agent authorized to pay customs duties and take possession of goods coming through Customs. No one may act as a Customs House Broker without a Customs House License. Because customs duties may range up to 20 percent plus on some products, the consignees, for cash flow purposes, may elect not to clear customs at point of entry, but instead, through the services of a Customs House broker, wait until the goods are shipped inland before clearing customs and paying the duties. Custom House brokers have to post a \$500,000 bond, to insure that if the goods are damaged or stolen during transportation, the duties on the goods will still be paid to Customs.

Deadhead -- Driving the tractor without a container.

Delivery Order -- A copy of the invoice containing the shipper, consignee, destination, description of goods, and weight.

Demurrage -- A fee charged by the shipping companies if the container is not returned timely.

Detention -- A fee charged by the railroad if the trailer is not returned timely.

Dispatcher -- The person who arranges the pickups and deliveries of freight and prepares the drivers' manifests.

Dock -- Area used to load and unload freight from one trailer to another (terminal).

Door-to-Door -- Pickup at the shippers dock (door) and delivery to the consignee's dock (door) that is handled by the same company.

Door-to-Ramp -- Pickup at the shippers dock (door) and delivery to the ramp of the railroad, ocean ship or airline carrier.

Drayage -- Pulling a trailer or container (cartage); the charges for transfer and cartage between stations, or to and from vessels on carts or trucks.

Exempt Carriers -- For-hire carriers who engage in moving specialized commodities which are exempt from government regulation. Most notable of these exempt categories is unmanufactured agricultural commodities.

Foreman -- Oversees operations on the dock.

Free Time -- Amount of time (days) the container can be used without any charges. Varies with the type of container and mileage distances.

Free Zone -- The area within a certain radius of the port-of-entry or harbor where a for-hire carrier is not required to be licensed by the ICC to transport freight between states.

Freight Broker -- An agent for the independent contractor that arranges jobs for independent contractors.

Freight Forwarder -- An agent who makes the arrangements for the transportation of freight from the shipper to consignee. The freight forwarder issues a through bill of lading from the origin to the destination, and takes full responsibility of the freight while it is in transit.

Glider Kit -- This is a kit to construct a tractor. It does not contain an engine or a transmission.

Haul-away -- Trailer used to move cars and trucks.

House Airway Bill -- Air freight bill of lading for a single shipment of freight.

Interline (line-haul) -- Agreement between shipper and transportation company that specifies the modes of transportation and identifies the specific carriers to be used.

Interchange -- The transfer of equipment from one carrier to another.

Intermodal -- Term used in describing transportation of freight combining the use of railroads and trucks, usually for long distances. Competitors to intermodal transportation providers are the long haul trucking firms.

Labor Leasing -- The practice of leasing employees (both drivers and office staff) instead of hiring them. The labor leasing company is responsible for paying employment taxes and filing the tax returns.

Less Than Truck Load -- A shipment of loose freight, as opposed to a full sealed container.

Landbridge -- Porthaulers who transport freight from the harbor to the railroad.

Linehaul -- Movement of freight from the point of origination to point of destination.

Longshoreman -- Ocean carrier cargo handler that loads and unloads freight at the harbor.

Lumper -- Cargo handler of agricultural products that is usually paid by cash payment.

Manifest -- Schedule of freight pickups and deliveries.

Master Airway Bill -- Summary of the house airway bills for a single container.

National Motor Freight Traffic Assoc. Inc. -- An organization which compiles and sets tariffs for various states, including California. A yearly fee is paid to use their classifications and tariffs. A similar organization is the Western Motor Tariff Bureau.

Non-Vessel Operating Carrier (NVOCC)

A consolidator of freight for an ocean carrier that is regulated by the Federal Maritime Commission.

Onloading -- Loading freight at the shipping end, point of origination.

Offloading -- Unloading freight at the receiving end, final destination.

Over The Road -- Transportation by tractor and trailer from one metropolitan area to another metropolitan area.

Owner-Operator -- A truck driver who owns and operates his or her own vehicle.

Piggyback -- Where the trailer is loaded onto a rail car.

Piggyback Agent -- Shipper's agent that books and schedules freight on railroad.

Porthauler -- A subhauler that picks up freight at the harbor and hauls it to the operations terminal or to the consignee.

Pre-Note -- Preliminary freight invoice used to schedule freight moves and prepare the final freight bill.

Prime Carrier -- A general common carrier with operating authority with either the PUC, ICC, or both depending on the type of hauling, intrastate or interstate. A prime carrier must post a \$15,000 subhauler (surety) bond with PUC/ICC. Designation as a prime carrier allows the company to solicit business directly from a shipper. If the company does not have the prime carrier designation, it can only work for another prime carrier as a subhauler.

Private Carrier -- Business that is registered with the PUC to transport and deliver their own goods.

Ramp to Door -- Pick up at the railroad and delivery to the consignee's door.

Reefer -- Refrigerated trailer.

Shipper -- The individual or company sending the freight to the consignee.

Shipper's Agent -- A transportation broker that arranges movement of freight.

Spotting -- Hauling empty trailers back to the railyard or container company.

Stevedore -- Cargo handler that loads and unloads freight from vessels at the harbor (longshoreman).

Subhauler -- An owner-operator that hauls freight for a prime carrier.

Swamper -- A truck driver's assistant that loads and unloads freight during the delivery of goods (lumper).

Tariff -- The rate that the carrier charges for the hauling of freight. These rates must be filed with either the PUC or the ICC depending on which agency is controlling.

Terminal -- Dock where freight is loaded or unloaded.

Tractor -- This is the power unit which pulls the trailer.

Trailer -- The vehicle that is pulled by a tractor in hauling freight.

Trailer Interchange Agreement -- Agreement between the carrier and container companies that spells out the amount of free time allowed, and the demurrage or detention fees to be charged for delays.

Transload -- The process of moving freight from ocean containers to domestic containers and vice versa. Ocean containers belong to the steamship lines and are not designed for transportation by truck or rail.

Transloading -- The act of unloading freight from a container trailer and loading it into a trailer bound for the consignee.

Truck Load (TL) -- A sealed trailer or container.

Warehouse -- Where goods are stored prior to delivery or distribution.

Yardgoat -- Tractor with a short turning radius which is used to pull trailers or containers within the freight yard and not intended for highway use.

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ABBREVIATIONS

ABI	--	Automated Broker Interface
ATA	--	American Truckers Association
CFS	--	Container Freight Station
CHL	--	Customs House License
CIF	--	Cost, insurance, freight
CNF	--	Cost, not freight
COFC	--	Container on flat car
COD	--	Collect on delivery
CY	--	Container Yard
DOT	--	Department of Transportation
FAK	--	Freight All Kinds
FCL-FOB	--	Free on Board
FMC	--	Federal Maritime Commission
HAWB	--	House Airway Bill
IASA	--	International Air Shipper's Association
IATA	--	International Air Transport Association
ICC	--	Interstate Commerce Commission
LO/LO	--	Lift on/lift off
LTL	--	Less than Truck Load
MAWB	--	Master Airway Bill
MTB	--	Motor Transportation Broker
MW	--	Minimum Weight
NVOCC	--	Non-vessel operating common carrier
OCP	--	Overland common point (revenue class)
OSDC	--	Over/Short/Damage/Claims
OTR	--	Over the Road
POD	--	Proof of delivery
POE	--	Point of entry
PL/PD	--	Personal Liability/Property Damage
PUC	--	Public Utilities Commission
RO/RL	--	Roll on/roll off
TL	--	Truck Load
TOFC	--	Trailer on flat car (that is, piggyback)
VOCC	--	Vessel operating common carrier (such as, ocean carrier)