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Consumer, and Monetary Affairs
Subcommittee, Committee on
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Representatives

September 1994

**TAX
ADMINISTRATION**

**Data on the Tax
Compliance of
Sweatshops**



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The Honorable John M. Spratt, Jr.
Chairman, Commerce, Consumer, and
Monetary Affairs Subcommittee
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

This fact sheet responds to your request that we examine compliance with federal and state tax laws by sweatshops in the garment and restaurant industries. You asked us to identify (1) the extent to which sweatshops in these industries complied with federal and state tax laws and (2) the efforts and resources that the Internal Revenue Service (IRS) and states used to correct any sweatshop noncompliance. Businesses that reduce their costs by not complying with tax and other laws pose an unfair competitive threat to businesses that do comply.

Experts have commonly described sweatshops as establishments employing workers at low wages, for long hours, under poor and unsafe working conditions. They usually violate labor and safety laws. They also may not comply with laws on paying employment (i.e., unemployment, social security, medicare, and withheld income taxes) and income taxes. When businesses do not properly pay and report wages, they can violate both labor and tax laws.

Federal laws and regulations do not define a sweatshop. Building on previous research, we defined a sweatshop as a business that violates more than one federal or state law governing wages and hours, child labor, health or safety, workers' compensation, or industry registration. The Department of Labor (DOL) and the Occupational Safety and Health Administration (OSHA) regulated such laws at the federal level.

Objectives, Scope, and Methodology

In trying to identify sweatshops' tax compliance, we found that IRS and state databases captured tax data for various types of businesses but not for sweatshops. According to IRS officials, the term "sweatshop" refers to those violating labor, health, and safety laws, not tax laws. Without such tax data, we could not measure the overall tax compliance for sweatshops. Instead, we collected federal and state data on elements of tax compliance for a group of sweatshops. The scope of our work precluded us from projecting these results to any population of sweatshops.

Using our definition of multiple violations of federal or state laws, we identified and collected tax data on a group of 69 garment sweatshops from three sources: (1) nationwide DOL and OSHA data, (2) a 1994 DOL study on California garment businesses, and (3) a New York state task force on garment businesses. For each source, we matched data on violations of labor laws and health/safety laws to identify the sweatshops.

We selected California and New York because they each had recent data on garment businesses as well as reputations for having more garment sweatshops than other states. We also identified 26 restaurant sweatshops from the national source but could not do so for the other two sources due to the garment industry focus at the two states.

For sweatshops in our study group, we sought IRS and state data on elements of tax compliance. For tax years 1990 through 1993, the data showed whether they (1) filed income and employment tax returns on time, (2) paid acknowledged tax liabilities on time, and (3) accurately reported their taxes.

IRS provided complete tax data for the 94 garment and restaurant businesses that met our sweatshop definition. Because of our scope and time constraints, we only sought state tax data from California and New York. California and New York were able to provide data on the filing of state tax returns but not on the two other elements. Finally, we could not get state data on 21 of the 26 restaurant sweatshops because they were located in states other than California and New York.

To identify efforts and resources to correct tax noncompliance by sweatshops, we interviewed IRS, California, and New York officials responsible for compliance. Because IRS and state databases did not identify sweatshops, data on resources were sparse. The officials could discuss efforts to improve tax and labor law compliance in industries that may have sweatshops.

We did our work between April 1994 and September 1994 in accordance with generally accepted government auditing standards. Appendix I has more details on our objectives, scope, and methodology.

Results in Brief

Although no data existed on the overall tax compliance of sweatshops, our work showed that many of those in our study group failed to comply with one or more elements of federal or state tax laws. Furthermore, these violators of labor and health or safety laws had a tendency to violate federal or state tax laws.

For example, of the 94 garment and restaurant sweatshops we studied, 84 (about 89 percent) were assessed at least one penalty for filing returns or paying their taxes late in one or more tax years between 1990 and 1993. As of mid-1994, 30 sweatshops still owed tax liabilities of \$492,000. Because comparable tax data were not available for other types of businesses, we

could not determine whether they complied better or worse in filing tax returns and paying taxes.

IRS identified most of these tax liabilities through audits, which offer the most comprehensive way to identify noncompliance. IRS had audited just 15 of the 94 sweatshops at least once during the 4 years we analyzed. Because the other 79 sweatshops had not been audited, their amounts of additional tax liabilities are limited to noncompliance caught through less comprehensive IRS enforcement actions, such as computer matching.

Lacking tax data on sweatshops, IRS and the two states could not focus enforcement efforts on pursuing any unpaid income taxes of sweatshops. In general, tax officials at IRS and the two states said they applied their limited enforcement resources to industries that tended to have larger amounts of unpaid income taxes. IRS officials said these industries are an enforcement priority and may include sweatshops, such as garment businesses.

For example, IRS and the two states had directed enforcement efforts at the garment and restaurant industries but not at the tax compliance of sweatshops. The state efforts tended to focus on violations of labor laws rather than tax laws. IRS' efforts included developing a nationwide audit program for the garment industry and hiring a national garment manufacturing specialist to coordinate that effort. IRS also organized a group in Los Angeles to address tax noncompliance in this industry and was planning similar groups in other states.

Officials at DOL and the two states generally favored working with IRS on joint compliance projects, such as for garment sweatshops. Such joint efforts could improve compliance with all laws, including tax laws. The federal tax code, however, restricts IRS' ability to share tax data in joint efforts.

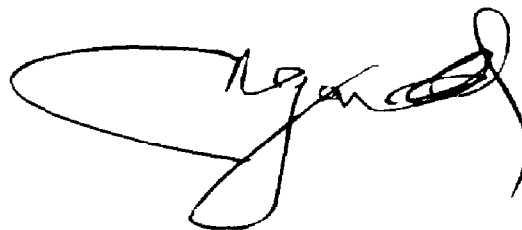
Appendix II provides more details on aspects of tax compliance with federal and state laws by the sweatshops we studied. Appendix III discusses the federal and state efforts to address tax noncompliance by garment sweatshops.

We received comments on a draft of this fact sheet during a September 14, 1994, meeting with IRS Examination officials, who represented the Assistant Commissioner for Examination and who oversaw the audits of garment and restaurant businesses. They generally agreed with our depiction of the facts but offered clarifications that we incorporated where appropriate.

As agreed with the Subcommittee, unless you publicly announce the contents of this fact sheet earlier, we plan no further distribution for 30 days. At that time, we will send copies to the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. We will also provide copies to others upon request.

Appendix IV lists the major contributors to this fact sheet. If you have any questions, please feel free to call me at (202) 512-9044.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Natwar M. Gandhi". The signature is stylized with a large, sweeping initial "N" and a long, trailing flourish.

Natwar M. Gandhi
Associate Director, Tax Policy
and Administration Issues

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Abbreviations

ASP	Audit Specialization Program
DOL	Department of Labor
EDD	Employment Development Department
EIN	employer identification number
IRS	Internal Revenue Service
MSSP	Market Segment Specialization Program
OSHA	Office of Safety and Health Administration
TIPP	Targeted Industry Participation Program

Objectives, Scope, and Methodology

Our objectives were to identify (1) the extent to which sweatshops in the garment as well as restaurant industries complied with federal and state tax laws, and (2) the efforts and resources that the Internal Revenue Service (IRS) and states used to correct any sweatshop noncompliance.

In attempting to answer the objective on tax compliance, we found that no federal or state data existed on the overall tax compliance of sweatshops because the term "sweatshop" refers to labor law rather than tax law. Therefore, we developed surrogates. First, we compiled a list of sweatshops in the garment and restaurant industries by applying our sweatshop definition (i.e., multiple labor law violators) to three sources. The first source identified sweatshops nationwide. The other two sources covered two large states (California and New York) where sweatshops were likely to exist in larger numbers than elsewhere according to DOL. Second, we analyzed specific elements of tax compliance for sweatshops in our list.

To identify sweatshops from the national source, we used nationwide databases from DOL and OSHA on businesses that violated labor and health/safety laws, respectively. Each database contained business names and addresses for fiscal years 1990 through 1993. To apply our definition of a sweatshop, we manually compared business names and addresses on the databases to find those with both types of violations. For the garment industry, we compared 123 DOL violators with 1,151 OSHA violators; for the restaurants, we compared 6,735 DOL violators with 2,309 OSHA violators. These comparisons produced 5 garment and 44 restaurant sweatshops.

We supplemented our nationwide sweatshop list by identifying California and New York sweatshops. We chose these two states not only because they reputedly had more sweatshops than other states but also because recent data existed on garment sweatshops in both states. However, neither state had recent data on restaurant sweatshops.

To identify the California sweatshops, we used data from a 1994 DOL study. DOL randomly selected 121 of 4,186 garment businesses identified by the California Employment Development Department (EDD), which is responsible for state unemployment taxes. DOL eliminated 52 businesses that could not be located, had gone out of business, or were not directly involved in the garment industry. DOL investigated the remaining 69 businesses for labor and health/safety violations. On the basis of violations cited by DOL, we found that 54 of the 69 businesses met our definition of a sweatshop (i.e., more than one type of violation).

The third source of sweatshop data came from the Apparel Industry Task Force at the New York Department of Labor. In focusing on labor law compliance, the task force created a list of garment businesses that had violated labor laws on the basis of 1,300 inspections. To identify sweatshops under our definition, we manually compared the New York list of labor violators to DOL and OSHA lists of business violators in the garment industry. This comparison identified 28 garment sweatshops, which included 1 sweatshop that we identified from the national source.

After accounting for this New York case, we identified 130 sweatshops from the three sources—86 garment and 44 restaurant sweatshops. These sources, however, rarely provided an employer identification number (EIN). We needed the EIN to obtain data from IRS and the two states on the elements of tax compliance (e.g., timely filed returns, accurately reported income). For businesses without an EIN, we asked IRS to research its databases, using the business name and zip code that we provided, to find any EINS. We eventually eliminated from further analysis 28 of the 130 sweatshops for which no EIN could be found.¹

The remaining 102 sweatshops with EINS included 26 restaurants and 76 garment firms. For the 102 sweatshops, we requested IRS tax transcripts for tax years 1990 through 1993. The transcripts identified whether the businesses filed all required income and employment tax returns and paid all related taxes on time. They also showed whether IRS took some type of enforcement action, such as an audit or computer matching for unfiled returns or unreported income. After reviewing IRS' data, we dropped from our analysis seven sweatshops that had been recently established (i.e., winter 1993-1994) and one that IRS had not recorded as having a requirement to file a tax return. We based our analysis on the remaining 94 sweatshops.

Given the scope and time constraints, we attempted to collect state tax data for the 67 sweatshops located only in California and New York. For the 46 sweatshops in California, the state could provide data on whether 44 of them filed their tax returns. New York could not provide specific tax data on each of the 21 New York sweatshops because a state law prohibited such disclosures. As an alternative, we asked for and received aggregated tax data on the 21 New York sweatshops. State tax data on the 26 restaurant sweatshops were especially sparse. We could only collect state tax data on 3 of the 5 restaurants located in California; the remaining 21 restaurants were in states other than New York.

We then analyzed the federal and state tax data. For each type of tax for each year, we determined the amount of additional taxes, penalties, and interest that IRS assessed against the businesses. We also identified the amount of tax delinquencies outstanding as of mid-1994. Given the lack of a sweatshop universe and the small number of cases analyzed, our results cannot be projected to any larger population.

¹Those without EINS could be nonfilers of tax returns or could reflect inaccuracies in the way the business reported or IRS recorded an EIN.

To identify efforts and resources for correcting tax noncompliance among sweatshops, we interviewed responsible tax officials at (1) IRS' National Office, Western Regional Office, and Los Angeles and Manhattan district offices and (2) California and New York state tax agencies. Data on such resources were sparse because IRS and state databases did not identify sweatshops. Even so, these officials could discuss efforts to improve labor and tax law compliance, particularly with labor laws, in industries that have tended to have sweatshops.

We also discussed the opportunities for and status of any joint compliance efforts among IRS, DOL, and the two states. As part of this effort, we analyzed the results of two 1994 joint investigations of garment sweatshops by DOL and California.

IRS and State Enforcement Showed That Sweatshops Tended to Be Noncompliant With Federal and State Tax Laws

IRS tax data did not allow us to determine the overall tax compliance of sweatshops. These data did allow us to determine whether the sweatshops in our group complied with selected tax elements. We determined whether these sweatshops (1) timely filed all required income and employment tax returns, (2) timely paid all acknowledged tax liabilities on these returns, and (3) accurately reported their taxes. Table II.1 shows our results on the filing and paying elements of federal tax compliance.

Table II.1: Compliance With Federal Tax Elements on Filing Returns and Paying Taxes for 94 Garment and Restaurant Sweatshops by Type of Tax Return, Tax Years 1990-1993

Tax element	Employment tax returns ^a	Unemployment tax returns ^b	Income tax returns ^c
Timely filed	62	74	90
Not timely filed	32	20	4
Nonfilers ^d	13	8	4
Timely paid	20	57	61
Not timely paid	74	37	33

Note: Numbers are based on 94 completed cases.

^aEmployer's Quarterly Federal Tax Return (Form 941) delinquent in one or more quarters during a 4-year period.

^bEmployer's Annual Federal Unemployment Tax Return (Form 940) delinquent in 1 or more of the 4 years.

^cBusiness Income Tax Returns (Forms 1065, 1120, and 1040 Schedule C) delinquent in 1 or more of the 4 years.

^dThese nonfilers are a subset of all those not filing on time.

Source: IRS Business and Individual Master File transcripts.

Table II.1 shows that many sweatshops did not comply with one or more of these tax elements. For example, of the 94 sweatshops, 32 did not timely file their employment tax returns, of which 13 did not file at all. Including these 32, 74 did not pay employment taxes on time. Data did not exist to show whether other types of businesses complied better or worse in filing returns and paying tax liabilities. Table II.2 shows the amounts of taxes, interest and penalties owed by the sweatshops.

Table II.2: Amounts of Federal Taxes, Penalties, and Interest Owed Among 94 Garment and Restaurant Sweatshops as of Mid-1994 by Type of Tax Return, Tax Years 1990-1993

Dollars in thousands				
Type of liability	Employment tax returns ^a	Unemployment tax returns ^b	Income tax returns ^c	Total
Original tax reported	\$644,528.0 ^d	\$13,533.7	\$19,302.7	\$677,418.4
Additional tax assessed	\$300.7	\$33.9	\$514.2	\$848.8
Interest and penalties	\$323.3	\$19.8	\$9.8	\$352.9
Total liabilities	\$624.0	\$53.7	\$524.0	\$1,201.7
Amount still owed	\$435.1 ^e	\$50.2	\$7.1	\$492.4

Note: Amounts are based on 94 analyzed cases.

^aEmployer's Quarterly Federal Tax Return (Form 941) delinquent in one or more quarters during a 4-year period.

^bEmployer's Annual Federal Unemployment Tax Return (Form 940) delinquent in 1 or more of the 4 years.

^cBusiness Income Tax Returns (Forms 1065, 1120, and 1040 Schedule C) delinquent in 1 or more of the 4 years.

^dIncludes two businesses that accounted for about \$552 million.

^ePart of this amount may not be actual liabilities because of errors the business made in reporting or IRS made in recording the employment tax information.

Source: IRS Business and Individual Master File transcripts.

As shown in table II.2, about \$492,000 is still owed IRS for the three types of taxes. We found that 30 of 94 sweatshops owed this amount, or about \$16,400 on average.

In addition to what tables II.1 and II.2 show, we found that 84 of the 94 sweatshops received one or more penalties for filing returns and/or paying taxes late. For example, IRS assessed delinquency penalties against 37 of the 94 sweatshops for not filing the required tax returns during tax years 1990 through 1993. Of the 37, 25 still owed \$418,113 to IRS as of mid-1994. As a result, these 25 accounted for about 85 percent of the \$492,000 still owed.

The total amount of noncompliance could be greater across all 94 sweatshops. We found that IRS audited 15 of the 94 sweatshops. Because they are more detailed than computerized checks of tax returns, audits are likely to catch more noncompliance. For example, these 15 audits accounted for about \$589,000 of the \$848,800 (about 70 percent) in the additional taxes assessed for the three types of taxes (see table II.2).

In addition to the federal tax data, we were able to collect state tax filing data from California on 41 garment sweatshops and 3 restaurants. Of the 44 sweatshops, only 6 did not file state tax returns. The state data did not allow us to determine whether the other 38 sweatshops filed a tax return on time or accurately or paid taxes on time.

We also collected aggregate state data on whether the 21 sweatshops in New York had filed the required state tax returns. New York reported that 15 of the 21 had filed a tax return at one time but were no longer filing, 1 had never filed a return, and 5 were compliant. New York state officials indicated that they would be sending notices to the 15 that had stopped filing tax returns.

Efforts to Correct Tax Noncompliance of Sweatshops Are Limited

Because IRS and California and New York state tax offices did not track sweatshops, we could not measure the resources applied to correct their tax noncompliance. These tax authorities had no tax compliance efforts directed at sweatshops. IRS Examination officials said that their enforcement efforts, given resource constraints, focused on industries with large amounts of tax noncompliance and that these industries may include sweatshops.

IRS and the two states did have some efforts devoted to the garment and restaurant industries. IRS' efforts in the garment industry tended to be small-scaled and did not target sweatshops. California and New York had efforts that focused on sweatshops but placed greater emphasis on the garment rather than on the restaurant industry and on labor law compliance rather than on tax law compliance.

IRS' National Enforcement Efforts

IRS had two nationwide projects that involved audits of garment manufacturers and contractors. A manufacturer coordinates all aspects in producing and selling garments to retailers. Manufacturers may contract out certain functions such as cutting fabric and assembling garments. A contractor performs these or other designated functions for a manufacturer. Contractors receive a negotiated payment per unit of work and have their own workforce, machinery, and facilities.

IRS did these two garment projects under its Audit Specialization Program (ASP), which has evolved into IRS' nationwide Market Segment Specialization Program (MSSP).² ASP audits addressed compliance in particular types of businesses owned by individuals or corporations and represented a small portion of all IRS audits.³ For example, IRS also audited garment businesses outside of ASP through its more general audit programs.

Table III.1 provides ASP audit results for fiscal year 1993. It shows that the two garment projects, compared to other projects, tended to be relatively productive in the revenue generated per audit and per audit hour. None of

²IRS is starting to develop its enforcement efforts around market segments (e.g., particular types of taxpayers or businesses). Under MSSP, IRS is developing expertise on each segment as well as unique ways to address related compliance issues.

³IRS did 1.3 million audits of all types of tax returns (largely individual and corporate) in fiscal year 1993 (the most recent year). These audits recommended \$23.1 billion in additional revenue (i.e., taxes and penalties), or \$17,751 per audit. On the other hand, IRS did 9,150 ASP audits and recommended \$132.8 million in additional revenue, or \$14,514 per audit.

the ASP projects isolated sweatshops or covered restaurants, except for fast food operations.⁴

Table III.1: IRS Audit Results for ASP Projects, Fiscal Year 1993

Type of ASP project	Number of returns audited	Recommended revenue (in millions)	Revenue per return	Revenue per audit hour
Auto dealers	2,593	\$27.1	\$10,460	\$380
Construction ^a	2,354	57.0	24,235	988
Motion pictures	773	1.7	2,154	201
Gas retailers	730	15.2	20,789	779
Laundromat	575	1.3	2,294	123
Health care	523	10.5	20,106	721
Garment^b	518	8.2	15,845	836
Attorneys	477	4.0	8,366	393
Commercial fishing	249	2.7	10,972	844
Taxi cabs	67	1.7	25,738	1,422
Travel agencies	60	.2	2,555	169
Fast food	50	.2	4,049	149
Other ^c	181	3.0	16,343	1,078
Total	9,150	\$132.8	\$14,515	\$ 628

Note: We collected preliminary ASP results for part of fiscal year 1994. Although incomplete, 1994 results generally indicated that IRS' audits have generated about 33 percent more revenue per audit hour and per return compared to 1993. Partial-year results for garment audits generally increased at similar rates.

^aIncludes two construction projects.

^bIncludes two garment projects.

^cIncludes seven projects: air charter, bed and breakfast, trucking, mortuaries, reforestation, rehabilitation tax credit, and wine industry.

Source: IRS Table 37, Category VIII Projects, nationwide, fiscal year 1993.

IRS' Los Angeles District Office Projects

IRS' Los Angeles District Office has a project on the garment industry. Compared to ASP projects, this project is more likely to deal with sweatshops. Specifically, the district is working with the Franchise Tax Board, EDD, and the Department of Labor Standards in California and with DOL and the U.S. Immigration and Naturalization Service to identify compliance problems with garment contractors in Los Angeles County. IRS officials believe that this project, although fairly new, has the potential to improve tax compliance in the garment industry.

To address tax compliance in the garment industry, the district first researched IRS records to identify garment manufacturers that had made large payments to contractors. District staff then reviewed these contractors' tax returns to identify those least likely to be compliant and worthy of an audit.

⁴IRS has been developing a special audit guide for the whole restaurant industry.

This district also has an outreach program to educate garment employers on federal tax responsibilities. IRS officials said that about 100 members of the Chinese Garment Association of Southern California attended a seminar hosted by Chinese-American revenue agents from IRS. The agents emphasized the importance of complete and timely business records and tax returns. IRS officials said IRS plans to hold similar seminars with the Hispanic community in conjunction with the Garment Workers' Justice Center and the Coalition of Apparel Industries.

IRS is developing similar garment projects with Florida, New York, New Jersey, and Texas. These IRS projects are being coordinated by a nationwide garment manufacturing specialist. In addition, IRS is implementing several joint projects with states on the restaurant industry in Kansas, Oklahoma, Illinois, Virginia, New Jersey, Louisiana, and Vermont, although the emphasis is on the tips paid to workers.

State of California

California is participating in the Targeted Industries Partnership Program (TIPP). TIPP is a federal-state effort that involving DOL, the California Department of Industrial Relations, and the California EDD. The objectives of TIPP follow:

- Maximize enforcement and educational efforts by focusing on industries that regularly have violated labor laws and have employed significant numbers of lower paid employees.
- Increase the level of voluntary compliance by educating employers on their employment responsibilities.
- Prevent businesses that violate labor laws from putting other employers at a competitive disadvantage.

Focusing on businesses with a history of violations, TIPP initially targeted agriculture and garment manufacturing employers for a 2-year pilot study that DOL began in November 1992. In March 1994, DOL issued a report on results from the first year. The penalties assessed by DOL and the state of California exceeded \$4 million.

State of New York

The New York State Department of Labor's Apparel Industry Task Force has been attempting to correct labor noncompliance within the garment industry. State investigators can make unannounced raids on suspected sweatshops. Upon finding violations of state, local, or federal laws, the task force attempts to alert the appropriate regulatory agencies such as DOL's Wage and Hour Division and OSHA. This task force did about 1,300 inspections in fiscal year 1993 to identify violators of labor and health/safety laws in the state.

IRS Coordination With Other Agencies

In reviewing IRS' efforts, we noticed that IRS rarely worked with DOL to improve compliance among garment sweatshops. DOL officials said they would like to work more closely with IRS in joint efforts. Doing so could enhance tax as well as labor compliance efforts.

IRS officials pointed out that a major barrier to joint projects is Internal Revenue Code section 6103, which restricts IRS' ability to share tax data. As a result, IRS' partners in joint projects tend to provide much more data than they receive. According to DOL officials in New York, coordination with IRS is limited. For example, they said they have referred two garment cases to IRS, but IRS has not shared the results of any audit work on these cases because of the disclosure law.

This restriction on sharing tax data has hampered at least one joint effort with DOL. In it, DOL drafted a special memorandum of understanding to govern information sharing and provided it to IRS along with the results of its investigations of five garment manufacturers that violated multiple labor laws. According to IRS officials, IRS could not share the results of the referred investigations with DOL because of section 6103.

Our work uncovered two examples in which information sharing and joint efforts may be helpful. For example, in tracking recent DOL inspections of California garment businesses, we noted that DOL collected data at each business on the number of employees and amount of wages paid. We compared the DOL data with data that these businesses reported to IRS and California on tax returns. We found, in reviewing a February 1994 garment industry inspection, that DOL recorded 40 employees at a business. Yet our review of state tax information revealed that the business only reported 2 or 3 employees throughout the first quarter of 1994. By not reporting all employees, the business can avoid paying employment taxes as well as meeting other requirements (e.g., minimum wages and hours).

In another example, DOL fined the business for paying wages to its employees of \$265,700 in cash without withholding the required taxes. According to its July 1994 report, DOL provided this information to IRS. At the time we reviewed the federal tax data as of August 1994, IRS had not had time to act on this information. IRS officials said that this information may be useful in identifying withholding noncompliance.

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