Market Segment Specialization Program

Bars and Restaurants

Training 3149-118 (Rev 11-2002)
TPDS No. 83849L

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

BARS AND RESTAURANTS
Table of Contents

Page

CHAPTER 1, INTRODUCTION

History of the Bars and Restaurants ES&TG....1-1
Overview of the Industry....1-1
Method of Accounting....1-4
Using the Bars and Restaurants Guide....1-5

CHAPTER 2, GENERAL INFORMATION

Books and Records....2-1
Internal Controls....2-4
Point of Sales Systems (POS)....2-5
Operating Ratios....2-9

CHAPTER 3, INITIATING THE AUDIT

Pre-Audit Planning ─ IRM 4.10.2.6.1....3-1
  Setting the Scope....3-1
  Ratio and Statistical Analysis....3-1
  IRS Research....3-3
  Coordination with Employment Tax Group....3-3
  Using the Intranet/Internet to Research....3-3
  Non-third Party Public Records Research....3-3
  Pre-audit Cash T....3-5
Initial Taxpayer Contact and Information Document Request (IDR)....3-5
Initial Interview ─ IRM 4.10.3.2....3-5
Tour of the Business Premises ─ IRM 4.10.3.3....3-9
Package Audit....3-10

CHAPTER 4, PROFIT AND LOSS STATEMENT

Examination of the Profit and Loss Statement....4-1
Minimum Income Probes....4-1
Additional Income Probes and Indirect Methods ─ IRM 4.10.4.6....4-3
  Specific Items methods of Determining Income ─ IRM 4.10.4.5.2....4-3
  Bank Deposits Method....4-5
  Net Worth Method....4-6
  Percentage Markup Method of Determining Income ─ IRM2.4.6.6....4-6
  Employee Tip Income ─ Reconstruction Using Indirect Methods....4-11
Other Income....4-12
  Income from Coin-Operated Activities....4-12
  Other Sources of Income Activities....4-12
  Rebates from Suppliers....4-13

Page

CHAPTER 5, AUDIT ISSUES AND TECHNIQUES ─ EXPENSES

Cost of Goods Sold 5-1
Purchases....................5-1
Inventory 5-1
Other Issues Affecting Cost of Goods Sold 5-1
Other Expense Issues 5-2
Package Design Costs 5-2
Charitable Contributions of Food Inventory 5-2
Depreciable Life of Restaurant Smallwares Asset Account 5-3
Amortization Goodwill and Covenants-Not-To-Compete....................5-3
Treatment of Liquor License Costs....................5-3
Treatment of Franchise Costs 5-3
Depreciation of Restaurant Buildings 5-4
Sale of a Restaurant ─ Income Issues 5-4
Losses Incurred When a Restaurant Closes 5-4
Capital Gains on Sale of Business 5-4
Ordinary Income Loss on Sale of Business 5-5
Income from the Discharge of Indebtedness or IRC section 108 Reductions for Tax Attributes 5-5
Taxable Liquidating Distributions to Shareholders 5-5
Unused Carryovers, Credits, Recapture Issues 5-5
Credits....................5-6
Credits for Taxes Paid on Certain Employee Tips....................5-6
Work Opportunity Credit (WOTC)....................5-6
Welfare to Work Credit 5-6
Disabled Access Credit 5-6
Empowerment Zone Credit....................5-7
Energy Credit 5-7
Rehabilitation Credit....................5-7
Enterprise Zone Credit....................5-7
Research Credit....................5-7

CHAPTER 6, AUDIT ISSUES AND TECHNIQUES ─ BALANCE SHEET

Examining Balance Sheet Accounts 6-1
Cash Account ─ IRM 4.10.3.8.4.1....................6-1
Stale Checks....................6-2
Credit Card Sales versus Cash Sales....................6-3
Cash Sales 6-4
Inventory ─ IRM 4.10.3.8.4.3 6-4
Loans to Shareholders ─ IRM 4.10.3.7.6....................6-6
Fixed Assets ─ IRM 4.10.3.7.7....................6-7
Intangible Assets. ─ IRM 4.10.3.7.8....................6-8

Page

CHAPTER 7, EMPLOYMENT TAX ISSUES
Package Audit ─ Internal Revenue Manuel....7-1
Employment Tax Compliance 7-2
Tip Income ─ Form 8027....7-2
Tip Rate Determination and Education Program (TRDA and TRAC)....7-3
Discussion of McQuatters Formula 7-6
Employer Only FICA Assessments....7-7

APPENDICES

Appendix 1 Glossary of Terms and Measurements A-1-1
Appendix 2 Audit Checksheet ─ RRA '98 ....A-2-1
Appendix 3 Common Methods and Indications of Under Reporting Income A-3-1
Appendix 4 101 Ways to Steal from a Restaurant A-4-1
Appendix 5 Operating Ratios....A-5-1
Appendix 6 Point of Sales System ─ Employee Tip Reports....A-6-1
Appendix 7 Citations and Resources A-7-1
Appendix 8 Restaurant Brochures, Posters, Publications, and Forms A-8-1
Appendix 9 Intranet and Internet Resources A-9-1
Appendix 10 Bibliography....A-10-1

This page left intentionally blank.

CHAPTER 1

INTRODUCTION

HISTORY OF THE BARS AND RESTAURANTS ES&TG

The Examination Specialization & Technical Guidance (ES&TG) initiated studies of specific industries in certain districts. As a result of these studies, Audit Technique Guides were written to assist revenue agent examiners with the examination of specific industries that have unique accounting systems, terminology, and operations unlike other industries.

The 2002 ES&TG Audit Technique Guide for Bars and Restaurants (the ATG) replaces the prior guide for Bars and Restaurants that was last revised in 1995. Changes to the ATG were necessitated by the passage of the IRS Restructuring and Reform act of 1998 (RRA98), as well as advances in accounting technologies used by restaurants. This Guide also considers relatively new examination research techniques available to revenue agents, including the Intranet and Internet. In the areas of employment taxes and tip reporting, this Guide takes into account significant changes recently made to Tip Rate Determination Agreement (TRDA) and Tip Reporting Alternative Commitment (TRAC) agreement. Employers can now sign up for these agreements using the Internet. This Guide considers these changes in statutes, technology and practice as they affect the revenue agent and the bar and restaurant industry.

One goal of the ES&TG Program is to reduce audit cycle time by helping agents become familiar with specific industries prior to starting an examination. This reduction of audit cycle time is a key goal in establishing customer satisfaction. In a recent national survey report of customer satisfaction, suggestions for improvement included, "when an auditor does not understand the business he or she is auditing, the outcome can be unfair. Appealing the outcome is out of the question, because the loss of income in appealing is greater than the amount owed the IRS." Understanding the industry being audited is essential to determining the correct tax liability, fairly administering the tax laws, reducing audit cycle time, and increasing customer satisfaction.

OVERVIEW OF THE INDUSTRY

Statistics published by the National Restaurant Association (NRA) state that restaurant sales are projected to be $399 billion in the year 2001 and, on a typical day in that year, the restaurant industry will post average sales in excess of $1.1 billion. Over 11 million people work in restaurants in America representing approximately 8 percent of the work force. Approximately 44 percent of

Americans eat at a restaurant at least once a day, and the average person consumes 4.2 meals prepared away from home a week. On an average day in 1998, 21 percent of U.S. households used some form of takeout or delivery. The average annual household expenditure for food away from home in 1998 was $2,030 or $812 per person. The restaurant share of the food dollar is 45.8 percent. Yet, it is also estimated that 80 percent of restaurants will close within 2 years of the date they open for business.

Restaurants can be divided into two types of restaurants: fast food and full service. Fast food restaurants include those that provide only take-out services, as well as franchises offering -in or drive-through services. Generally, customers do not tip employees of fast food restaurants. In contrast, full service restaurants and bars are generally privately owned and few are part of larger chains. A restaurant employee generally seats customers of full service restaurants. The menus and service are more customized than those of fast food restaurants and customers generally tip restaurant employees. The NRA states that average sales for full service restaurants in 1998 were $601,000; average sales for fast food restaurants in 1998 were $555,000. Also according to the NRA, the average per person check in a fast food restaurant in 1999 was $4.72.

In general, full service restaurants are individually owned and fast food restaurants are franchised. Franchisees typically pay a fixed percent of gross receipts to the franchiser for advertising and royalties. Franchisees will also purchase their inventory from franchisers and have their records regularly audited by the franchiser. Some fast food franchisers also lease the restaurant building to the franchisee for an additional monthly fee or percentage of sales. Internal controls of franchised restaurants are generally extensive and designed to detect fraud, waste, and theft. Individually owned restaurants may not have the same third party verification of income and costs.

The NRA maintains statistics regarding restaurant employees. For example: 7 out of 10 restaurants have fewer than 20 employees. The typical employee in a foodservice occupation is:

- Female (58 percent)
- Less than 30 years of age (59 percent)
- Single (71 percent)
- Living in a household with two or more wage earners (80 percent)
- Working part-time, averaging 25.5 hours a week.

The NRA has also determined that more than 60 percent of restaurants maintain an Internet web site. In fact, 13 percent of restaurant customers have used the Internet to find information about a restaurant. Moreover, as many as 10 percent of restaurant customers place orders over the Internet. Other restaurants permit customers to fax food orders to the restaurant before the customers arrive. More than two out of five households with a cell phone (41 percent) have used it to place an order at a restaurant for takeout or delivery. Such advances in technology are changing how restaurants service their customers. It is a challenge for both the restaurant owner and the IRS examiner to be certain that orders sent to the restaurant over the Internet, by phone, or by fax are properly recorded and that internal controls are maintained

Many states impose a sales tax on food. Some city/county governments also impose a sales or excise tax on food in addition to that collected by the state. Alcohol is also taxed and controlled by many state agencies. The examiner should contact his or her local Fed/State Coordinator to obtain information from state or local agencies that may be helpful in conducting the examination. IRS Strategy, Research, and Performance Management (SRPM, formerly DORA) has conducted studies comparing income reported on state sales tax returns with income reported on Federal income tax returns, and sales of alcohol reported to state liquor control boards with alcohol sales reported on Federal income tax returns. The examiner should contact SRPM for information obtained from these studies.

The bar and restaurant industry is particularly susceptible to theft and embezzlement. Bars and restaurants typically make numerous small dollar sales in a relatively short period of time (for example, lunch or dinner). Many employees receive and manage large amounts of cash. Some restaurants do not properly segregate the duties of their employees to the extent necessary to maintain good internal controls. This is especially true of bars where one bartender takes the order, fills the order, receives the payment, records the payment, and may even balance out the till at the end of the day. Bars and restaurants tend to pay their employees near minimum wage and have a high rate of employee turnover. Additionally, bar and restaurant employees often have access to large inventories of food and alcohol. For these reasons, bars and restaurants may have a high risk of employee theft and embezzlement unless they implement and maintain a set of good internal controls.

Some bar and restaurant owners may underreport income by any of several methods. For example, they may operate open tills, use double sets of books, and fail to report certain sales transactions. Restaurant employees may be aware of the owner's underreporting, and may even have been asked to assist in the underreporting of income. Additionally, a dishonest bar or restaurant owner may encourage dishonest employees. Bar or restaurant employees may underreport income by concealing cash receipts or underreporting tips.

The challenge for the examiner is to separate restaurant owners who are in compliance with the tax laws from restaurant owners who have failed to satisfy their tax obligations. To do this, the examiner should focus on 1) unreported income by the restaurant, 2) cost of sales, and 3) unreported tip income by the employees. While other issues may also be of concern to the examiner, these three issues will generally need to be addressed in the audit of a restaurant.

The NRA publishes considerable information and various statistics regarding the restaurant industry (See www.nra.com). Additionally, many states have separate restaurant associations with Internet links on the NRA website. These Internet resources may be helpful to the examiner involved in the audit of a restaurant, its owners or its employees.

The IRS is trying to educate taxpayers within the bar and restaurant industry. For example, the IRS often participates in State and National Restaurant and Food Industry tradeshows. Another educational outreach effort is the restaurant cite on the IRS Digital Daily web page at www.irs.gov. This web page contains information available to the pubic regarding restaurants and tip income reporting, and is linked to both the Small Business Administration and the NRA.

Choice of Business Entity: Bars and restaurants can operate as a sole-proprietorships, partnerships, subchapter C corporations, subchapter S corporations, or Limited Liability Companies (LLC). For tax years 1998 and after, subchapter S corporations are not part of TEFRA proceedings. Therefore, results of audit examinations must be given to all shareholders and statute extensions must be obtained from all shareholders of a subchapter S corporation. LLCs do not exist under the Internal Revenue Code (IRC). Unless an LLC elects to be treated as a corporation for Federal income tax purposes, the IRS treats the LLC as a partnership. As such, many LLCs may be subject to the TEFRA rules and proceedings for partnerships. The examiner must be aware of how the LLC is treated and whether TEFRA or non-TEFRA rules apply, since statute controls are different under TEFRA and non-TEFRA. Finally, a single-member restaurant owner will be subject to self-employment tax on all earning of a LLC. In Notice 99-6, 1999-3 I.R.B. 12, the IRS states that a single-member LLC can either elect to obtain its own employer identification number (EIN), file payroll reports, and make deposits under its own name, or it can continue to use the owner's EIN. The examiner should consult with his or her local Associate Area Counsel office regarding LLC shareholders' liability for the payment of the LLC's payroll taxes.

METHOD OF ACCOUNTING

Bars and restaurants generally maintain inventories of perishable goods and, therefore, have been required the use of the accrual method of accounting. For taxable years ending after December 17, 2000, Revenue Procedure 2000-22, 2000-1 CB. 1008, provides that a qualifying small business with average sales of $1 million or less for 3 years may use the cash method of accounting. The Revenue Procedure provides that if a taxpayer does not want to account for inventories, it must treat inventoriable items like non-incidental materials and supplies under Treas. Reg. section 1.162-3. For purposes of the revenue procedure, inventoriable items that are treated as non-incidental materials and supplies are considered consumed and used in the year in which the taxpayers sells the items, or, if later, when the taxpayer pays for the items. An accrual basis taxpayer can elect the cash method after 1999. Form 3115, "Change of Accounting Method" is required to be filed with the return. Revenue Procedure 2001-10, 2001-2 IRB 272, added that a business is allowed to use both the cash method and installment method of accounting and made it easier to elect the cash method. Tax shelters cannot receive relief under these revenue procedures. Issues may exist as to timing, proper elections, and whether a business has qualifying average sales.

Notice 2001-76 provides a proposed revenue procedure that allows qualifying small business taxpayers to use the cash receipts method. In general, a qualifying small business taxpayer has average annual gross receipts of more than $1 million but less than or equal to $10 million whose principal business activity is described in a North American Industry Classification System (NAICS) code that is not an ineligible NAICS code. The ineligible NAICS codes relate to mining activities (NAICS codes 211 and 212), manufacturing (NAICS codes 31-33), wholesale trade (NAICS code 42), retail trade (NAICS codes 44-45) and certain information industries (NAICS codes 5111 and 5122). Most bars and restaurants will fall under NAICS code 722 and may, therefore, be a qualifying small businesses. A Treas. Reg. section 1.162-3 non-incidental materials and supplies rule applies to inventoriable items. Although the revenue procedure is proposed, taxpayers may nevertheless rely on its rules for taxable years ending on or after December 31, 2001.

USING THE BAR AND RESTAURANT GUIDE

This guide is intended to be used by revenue agents specializing in the bar and restaurant market area, and by any other examiners working in this area. Since these examinations focus on basic income and employment tax issues, examiners with all levels of experience can use this guide. During the examination of bar and restaurant returns, the examiner will likely encounter taxpayer books and records of varying degrees of sophistication. Similarly, the examiners will likely encounter bars and restaurants with varying degrees of internal controls. The degree to which the examiner will limit or expand the scope of an examination depends largely upon the extent of these internal controls. It is important to note that if the examiner expands the scope of an examination to include employment tax issues, he or she should coordinate the examination of those issues with the area's employment tax group.

The purpose of this ES&TG Guide is to help the examiner become familiar with various accounting systems used by bars and restaurants, with issues common to bars and restaurants, and with effective audit techniques. If the examiner is familiar with these aspects of the audit, he or she can focus the examination accordingly. This ES&TG Guide is not intended as a substitute for the examiner's judgment. Every issue and audit technique referenced in this Guide may not necessarily apply to every bar and restaurant under examination. Additionally, issues which are unique to the industry and for which the IRS has a national coordinated position must involve the appropriate Headquarters ES&TG Facilitator for SBSE or Industry Specialist for LMSB.

This page left intentionally blank

.

CHAPTER 2

GENERAL INFORMATION

BOOKS AND RECORDS

As previously mentioned, the examiner may encounter varying degrees of sophistication in the books and records of taxpayers in the bar and restaurant industry. Some taxpayers may have technologically sophisticated accounting systems that provide very detailed records of food and liquor purchases and sales. Other taxpayers will not have any organized journals, and may only have cancelled checks and/or invoices for the items purchased. Still other taxpayers will have few if any records of any transaction and may conduct a large part of their business in cash

In recent years, technology has changed rapidly as applied to computerize accounting systems and the use of e-mail and electronic filing. For example, it is possible to have a point-of-sales system that allows the on-site server to push a key representing a menu item ordered by a customer. Simultaneously, the kitchen is notified of the order and inventory records are updated to reflect the sale. Inventory records may be updated using a menu cost pricing system, so that the cost of the sale is determined at the point of sale. Detailed cost analyses can be performed and summaries and projections can be generated. At month-end, the records can be e-mailed to an accountant, who will be required to provide few bookkeeping services and will have the data available to perform more financial analyses. At year-end, the unadjusted trial balance can be e-mailed to the accountant who will make the appropriate adjusting journal entries, prepare the final income statement, balance sheet, and the tax return. The completed tax return can be e-mailed back to the taxpayer, then electronically filed with the IRS.

Many point-of-sales systems are also designed to record employees' time and tips on a daily basis. This information is compiled for payroll accounting. Payroll checks can be written based upon the information provided, and Forms 940, 941, W-3, and W-2 can be prepared from the same computer program. This eliminates the need for an outside payroll service. Beginning in April 2000, employers can electronically transmit Forms 940 and 941 to the IRS. If the employer has more than 50 Forms W-2, however, electronic submission to the IRS is mandatory.

Note to examiner: If you suspect that the computer program used by the taxpayer is not recording all sales properly, a referral needs to be made for an IRS computer examination specialist who will run an audit test of the computer program. If the taxpayer is not properly using the program or doesn't know all of the reports that the program can run, you may wish to contact or have the taxpayer contact a manufacturer representative. Most programs made within the last decade run essential reports necessary to properly determine the correct tax liability and to comply with tip reporting requirements.

Clearly, advances in technology have increased the amount of data that can be collected by the restaurant owner, which can be used to comply with tax laws with minimal effort and greater reliability. Such advances in technology are also helpful to the examiner, who will need to complete fewer audit steps to determine the reliability of a taxpayer's books and records. Older accounting systems collect less data and do not have the built-in internal control mechanisms of modern point-of-sales systems.

The following is a list of possible books and records that will be found during the examination:

1. Daily cash register tapes including credit card sales, credit card tips, cash sales in total and by server
2. Deposit slips
3. Credit card and house account charge slips
4. Daily operating reports
5. Weekly profit and loss reports
6. Check register or copies of coded voucher checks
7. Bank statements for checking, savings, and all credit card sales
8. Bank reconciliation
9. Cash pay-out recaps (by account classification)
10. Inventory reports of food, liquor, beer, and wine done daily, weekly, and at year-end
11. Purchases recap and unpaid bills recap (vendor and account classification)
12. Equipment purchases (include copy of invoice)
13. Payroll records including time cards and time sheet and payroll summary
14. Accrued payroll and payroll taxes entries
15. Monthly and/or quarterly tax returns
16. Annual tax returns including Forms W-2, 1099, 8027, and related entities' tax returns
17. Books of original entry including: cash receipts journal; sales journal; general ledger; and working trial balance
18. Monthly financial statements including income statement, balance sheet, cash flow statement, and changes in financial position
19. Employee sales and tip report (daily, quarterly, and annual)
20. Menu engineers system report showing standard costs and sales price by menu item.

Cash Payouts

Many taxpayers in the bar and restaurant industry keep daily envelopes with the amount of cash paid out and the amount of cash taken in recorded on the envelope. All invoices and receipts for the purchases of food and liquor are kept in this daily envelope.

Cash Register Tapes

All transactions recorded in the bar or restaurant's cash register should be documented on a paper cash register tape. The level of detail and summary totals will vary. Some cash registers keep track of daily food by menu item, liquor, beer, wine, and other beverage sales. Some registers keep track of take-out orders, coupons, discounts, and banquet orders separate from regular menu sales. Some registers keep track by breakfast, lunch, dinner, and day of the week. Some registers keep track of sales per hour and/or the number of meals sold. Some machines keep track of customers served on a given check. Some registers automatically reduce inventory records by the menu item sold. Example: one cheeseburger menu selection will reduce bread, meat, and cheese inventory records accordingly. Some registers will keep track of credit card sales, credit card tips, cash sales in total and by individual server. The level of detail in the cash register system will aide in determining the level of internal controls and the reliability of the books and records.

Point-of-Sales System

A point-of-sales system typically records all sales by server and accounts for all transactions. A point-of-sales system creates internal controls that are non-existent without such a system. As an order is taken, the server records the order, which is simultaneously recorded in another computer that the kitchen uses to prepare the menu item. A ticket is printed and given to the cook to prepare the menu item selected. Another ticket is printed which is given to the customer upon payment. The server will note whether payment was made with a credit card or cash and the amount of the tip. The tickets are consecutively numbered which prevents servers from failing to ring up all sales without collaboration from the kitchen (separation of duties). Another built-in control is that the server must balance his or her sales against the cash register totals at the end of each shift in order to be paid tips from credit card sales. Newer systems require that the server report his or her cash tips on a daily basis at the time of balancing out. Newer systems also keep track of daily credit card sales, cash sales, credit card tips, and reported cash tips. Tips are reported to the payroll department. Newer systems are integrated to eliminate the need for outside payroll services. They can send information to a main terminal that can write payroll checks, complete and e-file Forms 940, 941, W-2, and W-3 as well as state tax reports.

Newer point-of-sales systems:

1. Require that the server report his or her cash tips daily during balancing out.
2. Keep track of daily credit card sales; cash sales, credit card tips, and reported cash tips. The tips are reported to the payroll department.
3. Are integrated to eliminate the need for outside payroll services. They can send information to a main terminal which can write payroll checks, complete and e-file Forms 940 and 941, Forms W-2, and Forms W-3.

INTERNAL CONTROLS

Older Cash Registers

Normal internal audit controls of a restaurant cash register will dictate that the restaurant owner never give the employee access to the "Z" key. The "Z" key will clear data and destroy the life-to-date cumulative readings of the machines. If an employee has access to the "Z" key, records of sales can be destroyed without an audit trail, making employee embezzlement of income possible. Likewise, an owner can also use the "Z" key for the same purpose, to destroy records of recorded sales. The life-to-date cumulative readings should never be cleared. Over-rings should be checked by management in a system which has internal controls. A daily accounting of guest checks numbers for each employee needs to be completed by the restaurant management in a system with good internal controls. Failure to complete any of the above indicates a lack of internal controls.

With older machines, the examiner needs to conduct audit tests to insure that internal controls are followed. For example, the examiner should sample the guest checks, compare them to the cash register tapes, and cross check the kitchen guest checks with the cash register copies to insure all menu items are being rung up. The examiner must discover and understand what procedures exist for credit card sales, for employee tips, and for servers to obtain cash payouts from the till. The examiner also needs to know how many employees have access to the till, and if the till is left open on a regular basis. The examiner also needs to know who has access to the "Z" key. A "Z" key is essential to knowing if all sales recorded on the machine are being reported on the tax return. An examination test may be conducted to determine if the "Z" key totals match the daily cash register tape totals if the examiner suspects the cash register tapes do not reflect all sales transactions recorded by the machine.

Point of Sales Machines

Point-of-sales systems record more transactions than older machines. However, they are only as reliable as the data input into the system. What is recorded tends to be accurate. What is not recorded is the problem with which the examiner should be concerned. The examiner must discover what items of income are not being recorded or input into the machines. The examiner also must discover if the machine is located where the customer can see the transactions and act as a double check that sales are being rung up accurately. The examiner needs to question the owner on the exact flow of the sale from the write-up of the initial guest check by the server through the kitchen and to the point of payment. Question the owner as to whether the cash drawer is closed after each sale or locked when unattended. Does someone do cash register readings other than the cashiers? Are readings done after each employee's shift? Are employees allowed to leave handbags, purses, or cosmetic bags at the cashier station? Who counts the cash banks?

When are deposits made? Are spotters ever used? Do the cashiers complete the daily reports? Does the owner employ surprise cash counts? Does the owner use spotting to be sure all cash transactions are being reported?

An examiner may not be certain that all sales are being rung up, that the owner is not using two sets of records, that the owner is not using two machines, or that the owner is not turning the machine off before the restaurant actually closes. For the examiner to know if all transactions are actually being recorded, an audit test check using the "Z" tapes needs to be run. The "Z" tapes contain the entire history of all transactions entered on that particular machine. If necessary, contact the manufacturer of the machine to provide instructions on how run a test using the "Z" key as some owners are not familiar with using the "Z" key.

The initial interview will help to identify the internal controls around the cash registers, but a sampling test of the procedures should be conducted by the examiner to determine if the controls are functioning as the restaurant owner represents.

POINT-OF-SALES SYSTEMS

A point-of-sales system normally includes a minimum of three stations where a personal computer (PC) is located. One PC is in the main office and has the database on it, another PC is used to ring up all sales as a cash register machine, and the third location is in the kitchen where the menu order is printed. Other machines can be located in the bar and at other check out points depending upon the size of the bar or restaurant.

Most of the newer point-of-sales systems are user friendly, allowing even a person who isn't literate to operate the machine by simply hitting a picture of the menu item when making a sale. Such simplicity minimizes personnel training. In an industry with high employee turnover and a generally unsophisticated work force, this is a cost savings device. The purchase of a point-of-sales system will usually include a computer program and hardware. The cost of the system can range from $5,000 to $40,000.

Employees sign onto the machines, which then track sales by individual employee. At the end of the shift, employees sign out. Most machines prompt the employee to report his or her tips for the day before the machines will allow them to sign out. A daily printout can be made for both the employee and the office showing the time signed in, all sales by credit card, credit card tips, cash sales, reported cash tips, and time signed out.

There are two types of banking systems that a bar or restaurant can use, namely, employee banking and cashier banking. The banking system used determines how tips are handled.

Employee Banking

Employees carry their own "pouches" or "purses" in which they keep money and sales receipts. Each employee is issued a certain amount of money at the beginning of each shift. This money is called a “bank.” Once this money is issued, the employee owes the bar or restaurant the amount in the bank. That is, the amount in the bank is regarded as a loan from the restaurant to the employee. The employees use the money in their banks to close their own checks (menu sales slips) and make change for customers. At the end of the shift the server “cashes out” by returning the bank to the bar or restaurant. The cashier or manager in charge of balancing out counts the money in the bank, subtracts the money originally loaned to the employee, and reconciles sales slips to the machine totals including credit card and cash sales. Then, the cashier or manager records the employee's cash tips and pays the employee the amount of his or her credit card tips. An employee Sales and Tip Total Report is run at the end of each employee's shift. Since this information is recorded in the back office computer or main terminal, the data can be accumulated and compiled to complete Forms 941, W-2, and 8027.

In this system of banking, the employee is considered to have reported his or her tips to the employer on a daily basis rather than on a monthly basis. At the point when the employee cashes out, the employer is liable for reporting the tips to the IRS on Form 941. The employer is aware of the amount of the employee’s credit card tips, as well as the amount received by the employee in cash tips. However, if the employee physically hides cash from the employer at the end of the day, when the employee cashes out, then the employer is not liable for the employee’s underreporting of the cash tips or the FICA tax on the underreported tips.

If the employee reports no cash tips, and the employer operates a large food or beverage establishment under IRC section 6053(c)(4), then the employer may be required to allocate 8 percent of sales as tip income to the employee and include the allocated tips on the employee’s W-2. Unless the employee keeps proper records of actual tips received, the employee is required to include allocated tip income on his or her personal tax return and pay the employee’s share of FICA tax on the allocated tips. The examiner should review Publication 531 on "Reporting Tip Income" for information regarding allocated tips.

Cashier Banking

In a cashier banking system, the server does not handle cash or record sales. Instead, an appointed person such as a cashier, manager, or bartender rings up all sales, records the payment from the customer, and issues and receives all cash to "close the guest check." In this system, the server punches the sale into the register, and a guest check is printed out showing the menu item and cost. It is also sent to the kitchen for meal preparation. When the customer is finished with the meal and is ready for the bill, the server delivers the guest check to the customer. The server receives payment from the customer. The server gives the money and the guest check to the cashier who rings up the sales and records the payment via credit card or cash and gives the cash back to the server to return to the customer or the credit card slip for the customer to sign. When the final sale is closed the cashier rather than the server completes it. The system tracks each server's charged tips and autogratuities. At the end of the shift, the cashier runs a report of the server's sales and credit card tip total. The server is asked to report cash tips before the system will pay the credit card tips to the employee. The cashier then pays the credit card tips and the autogratuities to the server

This system removes the server from control of funds. Control is placed in the hands of a designated employee such as a cashier. If the machine is not programmed to prompt the cashier to request the server to report his or her cash tips prior to cashing out, then this data may not be routinely collected. Most of the newer systems have a built-in prompt that will prevent the server from being paid his or her credit card tips without first reporting cash tips. The system does not prevent the server from failing to claim all of the cash tips he or she received. However, the system normally results in 100 percent accuracy with respect to credit card tips. As previously discussed, if the server reports no tips, the employer may be required to allocate tips at a rate of 8 percent.

***Note**: (Even if the employer allocates tips at an 8-percent rate, employees are still required to keep records of tips and to report 100 percent of the tips to the IRS on their individual income tax returns. If the employee has not reported all of the tips to the employer, then the employee reports 100 percent of the tips received to the IRS by completing Form 4137 with his or her return.)*

Newer point-of-sales systems are designed to compute employee tips as each credit card sale is made and to summarize credit card sales and credit card tips daily. Employee Sales and Tip Reports are normally done daily, no matter which banking system is used. Employee Sales and Tip Reports include the following totals in each report:

1. Gross receipts (total sales credited under the employee's name)
2. Credit card sales (total charged sales)
3. Credit card tips (total tips received from credit card sales by employee)
4. Cash sales (total cash sales under each employee's name)
5. Service charge receipts (total service charges payable to the employee)
6. Cash tips reported (total cash tips reported by employee)

This report may be compiled for each payroll period, quarter, or taxable year in a point-of-sales system. The Form 8027, "Employer's Annual Information Return of Tip Income and Allocated Tips," can easily be completed by running a simple report showing total sales, credit card sales, credit card tips, cash sales, and reported cash tips. Proper withholding of income tax and FICA against employees' earnings can be calculated with the information gathered. Proper reporting of the tips received and employment taxes withheld can be made on the quarterly Form 941 as a result of the information collected from an updated point-of-sales system. If the tips are allocated, IRC section 6053(c)(2) and Treas. Reg. section 31.6053-3(b)(1) and (2) require that the employer furnish the employee with a written statement showing the total tips allocated to the employee for the calendar year. This amount is required to be reported on Form W-2. The point-of-sales system calculates both the amount to be reported to the employee at payroll and the amount to be reported on Form W-2, saving time and expense in complying with tax reporting requirements.

In addition to employee tips, a point-of-sales system also tracks detailed inventory costs on a perpetual inventory system of accounting. As each menu item is sold, if the system has been programmed to keep track of menu pricing, inventory is reduced by each food item sold. The system prompts the owner to replenish certain menu ingredients as food items are sold and inventory is depleted. Because food items tend to be perishable goods, this tracking device can result in cost savings.

Reports can also identify the gross profit percentage of each menu item. As certain inventory costs go up, the owner can be alerted to these increases for purposes of determining whether to drop a menu item or increase its sales price.

A fully integrated point-of-sales system can keep track of a considerable amount of information and can generate many reports based on this information. The examiner needs to be aware of the information that is input into the system to know what reports are available for examination. The examiner should ask the taxpayer what reports are being generated. If certain ratio analyses or financial comparative analyses are already being generated by the system, it may be much simpler to request this information than to independently generate it. Assuming that all sales and cash transactions are properly input, fully integrated point-of sales-systems can generally be relied upon to accurately compute income. Once preliminary and mandatory audit tests of the reliability of the books or records are made, the examiner can focus on items that were never input into the point-of-sales systems and other examination issues.

Treas. Reg. sections 31.6053-1 and 31.6053-4 permit electronic reporting of tip income. An employer can adopt a system under which some or all of the tipped employees furnish their tip statements electronically. If the employer provides employees with a copy of the daily record of tips based on entries made by the employee in the employer's electronic reporting system, and otherwise satisfies the reporting requirements, the entry on a daily record will satisfy the substantiation requirements. For example, an employee may enter tips in the electronic system at the end of each shift and not provide the employer with a signed paper record of tips. At the end of each payroll period, the employer provides the employee with a paper record that includes all the information to satisfy the substantiation requirements and shows the total amount of tips reported for each day during the period based upon the employee's entries. If the employee retains the employer generated paper record, Treas. Reg. section 31.6053-4(a)(2) provides that substantiation requirements are met. The paper record must, however, contain the following:

1. the employee's name and address, the employer's name and name of the establishment;
2. for each workday, the amount of cash tips and charge tips received directly from the customer or other employees;
3. for each workday, the amount of tips paid to other employees through tip sharing or pooling and the names of those employees;
4. The date each entry of the record was made.

Under Treas. Reg. section 31.6053-4(a)(2) such records made at or near the time the tip income is received are considered to have a high degree of credibility.

OPERATING RATIOS

Most successful restaurants analyze costs by using operating ratios and, based on this data, making adjustments as needed to maintain profits. Usually, a company with a point-of-sales system will have the data already input into the system from which reports can be run. Some systems even complete a ratio analysis as an operating report. Many of the ratios themselves are useful only when compared to industry averages. The NRA has compiled statistics gathered from thousands of restaurants to create industry averages. Some of these statistics are listed in Appendix V at the end of this ES&TG Guide.

For the examiner to determine if the restaurant under examination falls within the industry averages, certain data must be obtained during the initial interview and tour of the business. For example, the examiner needs to discover the number of seats available to customers in the restaurant, the number of employees who work in the restaurant during a regular day (employee equivalent), and the square footage of the restaurant.

The use of statistical and ratio analyses is useful to the examiner in analyzing large and unusual items and in focusing on which items on the return to examine and the scope of that examination. Statistical and ratio analyses are not tests of the reliability of reported income or expenses and cannot be substituted for an income probe audit step. Rather, the use of statistics and ratio analysis may indicate that additional audit steps are warranted. The examiner still needs to perform audit tests to determine if the taxpayer’s books and records can be relied upon and must use direct or indirect methods to determine gross income. If necessary, however, ratios can be used to support audit conclusions arrived at using these methods.

Ratio patterns can indicate unreported income and suggest a need for additional income probes. For example, an analysis of a restaurant return indicates that the restaurant has suffered losses for 3 consecutive years or longer and has a high ratio of cost of goods sold to sales. It is reasonable to question the source of the cash necessary for the restaurant to continue operating under these circumstances.

Inspecting the cash flow statement may pinpoint potential sources and assist in preparing a Source and Application of Funds.

Additionally, if the ratio of sales per employee is low relative to the industry, it may be useful to inquire about the turnover ratio of the employees. If, by inspecting the Forms W-2 and payroll records, it appears that the turnover ratio is high, it may be reasonable to assume that the recurring cost of employee training is the cause of the relatively low sales per employee. A restaurant with high employee turnover may not be entitled to take the Work Opportunity Credits or the Welfare to Work Credit. (See IRC sections 51 and 51A.)

CHAPTER 3

INITIATING THE AUDIT

IRM Section 4.10.3.1: EXAMINATION TECHNIQUES PECULIAR TO CERTAIN SMALL BUSINESSES provides some insight into the examination of restaurants or cafes. Read this section before you begin as a way of becoming familiar with the basic concepts.

PRE-AUDIT PLANNING – IRM 4.10.2.6.1

Setting the Audit Scope

IRM 4.10.2.6.1 discusses the need to pre-select issues "…so that, with reasonable certainty, all items necessary for a substantially proper determination of the tax liability have been considered." Examiners are then expected to use their professional judgment to adjust the audit scope throughout the examination process as the facts and circumstances warrant. Consideration should also be given to IRM 4.10.2.6.1.1 and the appropriate use of limited scope examinations. Due to the cash intensive nature of the industry, it may be that income, cost of goods sold, and employment taxes are the only significant issues. If so, the audit scope may be limited to these three issues. If there are other large, unusual or questionable items, those issues should be addressed as well. The examiner's focus should be on the issues that will allow a determination of the "substantially correct" tax for all taxpayers.

Ratio and Statistical Analysis

As with any pre-audit plan, an analysis of the tax return should be conducted for potential issues. Ratio and statistical analyses will likely be very helpful in this regard. One form of such analysis, comparing amounts over time, will give meaning to changes that took place over time. Additionally, various ratios and statistics based on a taxpayer's financial information may be compared to those compiled by the NRA. A sample of the statistics published by the NRA can be viewed on its website: www.nra.com. Large percentage changes or percentages that are not standard for the industry can be highlighted as potential issues and areas where the initial interview should focus

An example of an important ratio that can be computed on the comparative income statement is the Gross Profit Ratio. It is computed as follows:

$$\frac{\text{Gross Sales - Cost of Goods Sold}}{\text{Gross Sales}} = \text{Gross Profit Ratio}$$

This ratio tells us approximately how much of an item's sale price represents gross profit and how much is a recovery of the cost of the item. During the initial interview, the taxpayer should be asked the mark-up percentage on goods sold. The percentage obtained from the interview can be compared to the computed ratio. A large disparity between these figures may indicate that cost of goods may be overstated or revenues understated.

Some restaurants use their own statistics in **menu pricing**. Menu pricing determines the cost of a menu item by identifying the various inventory items it contains and taking into account the cost of each inventory item. This allows the restaurant owner to determine a profitable selling price for the menu item with considerable accuracy. Menu pricing can be done manually or formulas can be programmed into the point-of-sales system. With a point-of-sales system, each item on the menu can also be tracked to see how frequently it is sold. Menu items with low sales or low profit margins can then be dropped. Take, for example, the sale of one hamburger. The cost of the meat, bun, vegetables, and spread can be determined. If that cost is $1, and the owner wants to make a 50-percent profit or mark-up over cost, then the item should sell for $1.50 with a 50-cent profit on each item sold. If the point-of-sales system shows that the restaurant sells very few hamburgers, that item may be dropped from the menu in favor of other items, which can be sold in greater numbers.

Many point-of-sales systems compute ratio analyses for the taxpayer in order to monitor costs and mark-up percentages. If the taxpayer can provide the examiner year-end financial ratios generated by the system, an audit step is saved and the examiner can begin analyzing the ratios provided. Ask the taxpayer if he or she uses menu pricing or is able to obtain system-generated financial ratios. The owner may need to contact the manufacturer's representative for the system, or read the owner's manual, to determine how to generate financial ratios.

Another report that most point-of-sales systems will print out is a "menu engineer report." While this report may go by another name, it will print out the standard food and alcohol costs for each menu item and the standard sales price for each menu item. The examiner needs to ask for this report even if the taxpayer doesn't use it. It will provide guidance as to whether the costs and sales prices are in line with the standard program provided by the manufacturer.

Appendix 4 provides a list of various financial ratios and how each is computed. Statistics provided by the NRA are also included in that Appendix. Updated statistics can be obtained from the NRA website.

IRS Research

Research IDRS, Forms 8300, Forms 1099 and Forms W-2, and other sources as appropriate for the entity under examination. Note: Forms 8027, "Employer's Annual Information Return of Tip Income and Allocated Tips," are not currently available on IDRS. Check with your local Tips Coordinator to determine if the restaurant under examination is filing these forms.

Coordination with the Employment Tax Group

As a mandatory pre-audit step, contact the local Tips Coordinator for your territory to determine if the bar or restaurant under examination has a current TRDA or TRAC agreement, or if they have ever been contacted or recently contacted about such an agreement. (See Chapter 7 of this ES&TG Guide for a discussion of TRDAs and TRACs.) The National Office has issued guidelines requiring that no TRDA or TRAC be offered to the taxpayer after it has been contacted for an income tax examination. (See Memorandum for Regional Chief Compliance Offers dated September 11, 2000 on the IRS Bulletin Board.) If there is a TRDA or TRAC agreement in process at the beginning of an income tax examination, the income tax examination will not be delayed. Instead, the tip examination will be delayed by the time specified in the TRAC or TRDA agreement. A taxpayer cannot request a TRDA or TRAC agreement after the income tax examination has started. If the examiner determines that a tip audit is necessary, he or she should work with the local area Tips Coordinator and employment tax group manager to complete that audit.

Using the Intranet/Internet to Research

Research the bar or restaurant's background information using the Internet. Does the bar or restaurant have its own website? Are there related entities? Is this restaurant mentioned in news services? Refer to Appendix VI for some useful websites. The IRS website ***www.irs.gov*** has a new icon for Small Business specifically divided by market segments. Research the IRS "Restaurant" site for updates on IRS issues and industry issues.

Use IRS Intranet bulletin board information to research industry related coordinated position papers on issues related to the food and beverage industry. Especially be aware of ES&TG and Office of Employment Tax Administration and Compliance (OETAC) information related to employment taxes and tips compliance measures.

Non-Third Party Public Records Research

Public records research does not require third-party notification. (See IRC section 7602(c) and IRM 4.10.1.6.12.) The examiner's discretion and the specifics of the examination determine the extent to which background research should be conducted using public records. It is an optional audit step that can be performed after the initial interview and preliminary audit steps are completed. For example, if the bar or restaurant either has no records or is not making records available to the examiner, the examiner will have to reconstruct income from third party sources. Public records may help to reconstruct income and expense, trace assets, etc. It may also be necessary to contact state liquor control boards, state auditing divisions, court cases, Bankruptcy Court records, etc. The following is a list of possible public record resources, many of which can be accessed via the Internet.

1. Sale and transfer of property
2. Mortgages and releases
3. Judgments, garnishments, chattel mortgages and other liens
4. Bankruptcy records
5. Conditional sales contract
6. Birth, deaths, marriages, and divorces
7. Change of name
8. Auto licenses, transfers, and sales of vehicles
9. Drivers' licenses
10. Hunting and fishing licenses
11. Occupancy and business privilege licenses
12. Building and other permits
13. Police and sheriff records of arrests
14. Court records of civil and criminal cases
15. Registration of corporate entities and annual reports
16. Parole officers' and probation departments' files
17. Registration of non-corporate business entities
18. School and voter registrations
19. Professional registrations
20. State income tax returns
21. Personal Property tax returns
22. Real estate tax payments
23. Inheritance and gift tax returns
24. Wills
25. Letters of administration
26. Inventories of estates
27. Welfare agency records
28. Workmen's compensation files
29. Bids, purchase orders, contracts, and warrants for payments
30. Minutes of board and agency proceedings
31. Health Department records
32. State Unemployment Compensation records.

Other Third Party Sources of Information for Bars and Restaurants

If you have reason to believe that the taxpayer may be underreporting his or her income, you may be able to confirm (or rule out) such underreporting by contacting third parties. Before you initiate a third party contact, make certain that you have followed the requirements of IRC section 7602(c) and IRM 4.10.1.6.12. If you have any questions regarding third party contacts, you should direct them to your local Associate Area Counsel office.

The following are possible third party sources of information that can aid you in the examination of bar and restaurant returns. All of this information may not be available in your state or it may be organized differently. You should research the sources available in your state to determine what information is available.

Alcohol Beverage Control	Demands that holders of on-premises licenses maintain available records of all purchases for 3 years.
State Liquor Dispensary	Maintains records of all purchases by liquor license number. Does not maintain the details of the purchases. Maintains records of the liquor costs for most periods of time.
Local Beer/Wine Distributor	Maintains records of purchases made by their customers. Maintains the records of the costs of the products.
Permits required by the State	That is, building permits, Health Dept. permits, or blueprints of the establishment which has the initial basis of the building, or certification of occupancy permits.

Pre-audit Cash T

Conduct an initial "cash T" based upon the information gathered and what is reported on the tax return. Update the "cash T" after additional information is gathered from books and records during the examination phase. Personal living expenses can be requested of the taxpayer only after the initial interview and tour of premises reveals a lack of internal controls and there are indications of unreported income on a Schedule C audit or the examination has been extended to include the shareholder/partner.

INITIAL TAXPAYER CONTACT AND THE INFORMATION DOCUMENT REQUESTS

Initial Contact

Schedule the initial contact with the taxpayer by phone and set up initial appointment and interview. Share preplanned issues. Schedule a meeting with the person most knowledgeable about the day-to-day operations of the restaurant. Arrange for a tour of the business. Have the Information Document Request

(IDR) prepared before the initial phone call. Adjust the request as needed before sending to the taxpayer.

The IDRs should be prepared using Form 4564. Form 4564 serves the following purposes:

1. Provides a written record of the information requested.
2. Provides the date of the request so follow-ups are timely.
3. Prevents the agent from requesting the same information on different requests.

See Figure 3-1.

Figure 3-1

Department of the Treasury
Internal Revenue Service
INFORMATION DOCUMENT REQUEST

The following is a sample of an IDR that can be used:

Description of Documents Requested

1. Copies of prior audit reports from either state or federal agencies.
2. Work papers used to prepare return, including trail balance and adjusting entries.
3. General ledger and all journals for the year ending December 31, xxxx, including the chart of accounts and a schedule or journal of all purchases made during the year with the supporting invoices.
4. Copy of prior and subsequent Federal income tax returns.
5. Copies of related business entities returns for years xxxx to xxxx.
6. Copies of Form 8027 for years xxxx to xxxx.
7. Corporate minute book, organizational records, and stock record book.
8. Copies of Forms 940, 941, W-2, and 1099 for xxxx and xxxx. Copies of current Forms W-4.
9. Copies of payroll records including hours worked and tips reported to employer for years xxxx-xxxx.
10. Copies of State Unemployment Tax Returns for xxxx and xxxx.
11. Inventory records, including detailed ending inventory schedule.
12. Bank statements and deposit slips for all checking, savings or brokerage accounts, and for all credit card reports for the period December 1, xxxx through January 31, xxxx.
13. Daily cash register tapes and daily cash reports including total sales, credit card sales, cash sales, and broken down by individual server.
14. Weekly profit and loss reports for xxxx.
15. Cash payouts and receipts for xxxx.
16. Records of treatment of employee meals coupons, discounts, and gift certificates.
17. Employee Sales and Tip Reports for daily/quarterly/annual.
18. Schedule of all loan proceeds, sources, and repayments.
19. Documentation of all nontaxable income.
20. Detailed depreciation schedule.
21. Copies of shareholder's individual income tax returns for xxxx and xxxx.
22. A tour of the business facilities during regular operating hours the day of the first appointment.
23. Interview with the owner and/or manager responsible for day-to-day operations.
24. Copy of menus for breakfast, lunch, dinners and alcohol and wine for xxxx.
25. Copies of meal pricing menu reports.
26. Cancelled checks and invoices for food and alcohol purchases including record of waste, spoilage, and theft.
27. Cancelled checks and invoices to verify the following expenses:
28. Please provide the following by the following Date: ________________

INITIAL INTERVIEW – IRM 4.10.3.2

The initial interview should be conducted with the owner of the establishment. If the owner (or majority shareholder) does not work in the bar or restaurant, the manager who knows its day-to-day operations should also be interviewed. The primary objective is to acquire general information about the establishment and its normal operations. Information such as gross profit ratios, mark-up percentages on food and alcohol, and costs of food or alcohol items need to be addressed in the initial interview. The initial interview will help the examiner gather the information necessary to identify internal controls present in the bar or restaurant. Based upon these internal controls, the examiner will determine the extent of the income probe to use. Per IRM 4.10.4.4.3, strong internal controls generally suggest minimum income probes, while poor internal controls generally necessitate the use of at least one indirect method and/or third party contact.

A well-conducted initial interview will help the examiner focus the examination on the relevant issues necessary to determine the taxpayer's correct tax liability. A poorly conducted interview or an interview in which the owner and/or on-site manager are not present will require additional audit steps to obtain the information necessary to determine the taxpayer's correct tax liability. This will create delays in the examination. It is important that this is conveyed to the owner and/or his or her representative to expedite the examination and to avoid unnecessary delays. If the owner or manager familiar with day-to-day operations doesn't want to appear for an interview, consider the use of a summons. However, before you serve this summons, make certain that you are familiar with the requirements for an effective and enforceable summons. (See IRC sections 7602, 7603, 7605 and 7609, as well as IRM Handbook 109.1.) If you have any questions regarding the use of a summons, contact your local Associate Area Counsel office.

At the conclusion of the interview and business tour, it is important to write a narrative of what transpired and what information was gathered. In this narrative, document the internal controls that were discovered (and those that were missing), describe the accounting system, and indicate what you observed during the tour of the business (See IRM 4.10.3.4.1 and 2). Consider drawing a flow chart to document how the restaurant system operates. Check back with the taxpayer/representative to be sure that you have a correct understanding of the business operations and internal controls before continuing your examination. If the case is later transferred, the next examiner will not have to request the information again in order to understand the operations of the business.

See Exhibit 3-1 for a sample of questions prepared for an interview of a bar and restaurant establishment. You may want to add, subtract or reorganize the questions depending on the particular circumstances of your examination.

TOUR OF THE BUSINESS PREMISES ─ IRM 4.10.3.3

Treas. Reg. section 301.7605-1(d)(3)(iii) states: "regardless of where an examination takes place, the Service may visit the taxpayer's place of business, or residence to establish the facts that can only be established by direct visit, such as inventory or asset verification. The Service generally will visit for these purposes on a normal workday of the Service during the Service's normal tour of duty hours."

A tour of the business premises is essential to the examination because it provides an overview of the business operations. Unnecessary audit steps may be avoided if the examiner is able to quickly understand the bar or restaurant's operations by inspecting its business premises. It is preferable to conduct this tour while the bar or restaurant is open. If this is not possible, it may be appropriate to eat at the bar or restaurant and observe the way that sales are rung up and they way that cash is accounted for. This audit technique is known as "spotting."

Prior to the tour, ask for a copy of the food and bar menus and a depreciation schedule. During the tour, note the following:

1. Number of chairs and tables. (Note: the NRA has compiled statistics on the average sales per year per chair based upon the type of restaurant. This information is necessary to conduct ratio analysis).
2. Location of the cash registers.
3. If the cash registers are left open at all times.
4. Which employees have access to the sales registers.
5. Where the register inputting to the kitchen is located.
6. If a buffet or individually prepared meals is being sold. The number of sales of individually prepared meals can be accounted for by the kitchen, but not for a buffet style meal. The kitchen can estimate the number of meals served based on leftover food.
7. If there is a banquet room and how many seats are available.
8. If there is a bar and whether food is served in the bar.
9. How the bar sales are rang up, and how inventory is controlled.
10. If décor is appropriate to depreciation schedule.
11. If items on depreciation schedule are missing from tour and inquire as to why. Notice if items of equipment are in the restaurant but not on the depreciation schedule. Inquire as to why.
12. If there is a computer in the back office attached to the registers. Have the owner explain how the sales entered into the cash register machine get posted to the main office computer.
13. If there are vending machines in the restaurant, how many, and type.
14. What credit cards the restaurant is accepting. Usually a list of which credit cards are accepted is located near the door or near the main register. Request credit card monthly statements to insure all credit card sales are being reported.
15. If pull-tabs are being sold.

16. If video games are installed and income reported.
17. Ask the taxpayer to show where cashier machines are located and how the sales are handled, controls, where data is entered and rung up. Look at the keyboards and get a demonstration of what reports that particular machine can run. (Note: more sophisticated point-of-sales systems mean better records and a better system of internal control. Obtaining this information up front is essential to know whether to limit or expand the examination).

PACKAGE AUDIT

1. Obtain and review Chart of Accounts - IRM 4.10.3.5. Reconcile books to return. Review adjusting and closing entries.
2. Complete a comparative analysis of income statement and balance sheet for prior and subsequent years to assist in setting the scope of the exam. Look for large or unusual variances.
3. Analyze Schedule M-1 and M-2 ─ IRM 4.10.3.6. Items should be carefully reviewed to determine the reasons for differences between income shown on the books of the corporation and taxable income shown on the tax return. Possible book to tax differences for a restaurant are meals and entertainment limitation; depreciation; shareholder's wages/bonuses accrued but not paid in the tax year; and officer's life insurance premiums. Based upon this analysis, determine if additional issues exist to warrant further probing.
4. Organizational Information: Review articles of incorporation, corporate minutes, stock register, partnership agreements, LLC operating agreements, and LLC articles of organization.
5. Prior and Subsequent Year Returns ─ IRM 4.10.5.3.
6. Related returns ─ IRM 4.10.5.4. Review shareholders, officers, related corporations, partnerships, etc. Process delinquent returns.
7. Employment tax returns ─ See Chapter 7 of this ES&TG Guide.
8. Cash Transactions ─ IRM 4.10.5.7 and Exhibit 4.10.5-5, IRM 4.3.4. Ensure taxpayer's knowledge and compliance with Form 8300 and currency reporting requirements. Query CBRS for monetary transactions and consult coordinator as appropriate.
9. Compliance referrals (if applicable).
   a. File information reports on employees who are non-filers and/ or have unreported tips.
   b. Initiate taxpayer education efforts for TRDA and TRAC outreach.
   c. Employment tax referral as warranted. (See Chapter 7 of this Guide).
   d. Computer Assisted Audit - IRM 4.47.1.
   e. Engineers (Form 5202) IRM 4.48.1 (mandatory for valuation issues).

Taxpayer Name:
Examiner:
Form/Years:
Date:
Workpaper Title: ***Initial Interview***
Interview conducted with:
Interview conducted at:

Explain Audit process, privacy rights, appeal rights
Any prior Audits?
Observation of Business…

Ownership
- Who are the shareholders in the S-Corp/C-Corp, percent ownership, duties,
- hours worked, days worked?
- Who are the beneficiaries/partners in Trust/Partnership, if any?

Name	Days in	Time in	Duties	Experience	Education

- What are the related return/transactions – that is, is rent paid to a related person? (Obtain copies)

- Loans – is there a note, amortization schedule? (Taxpayer to construct if none)

Description of Business
Type of Restaurant
Type of menu?
What is the entertainment?
Banquets available during normal operating hours? Any during off-hours?
Hours of operation?
Days open?
What type of clientele frequents the restaurant?
Who is the accountant, if changed why?
What did the accountant do? That is, return preparation only? books and records?
Who was the bookkeeper in xxxx? If different than present, why did the prior bookkeeper leave? How long worked?

How much of the bookkeeping is done and/or kept at the business site? Does the owner have an accountant or bookkeeper that maintains his own bookkeeping system?
Who does the year-end adjusting entries?
Any change in business - recording system or input/register systems, employees, and managers?
Different bookkeeper? Why?

Management of the Restaurant

Who runs the business? Family-operated/management-operated? Experience? How long?
What are the duties of those who run the business?
Daily, closing, cash, receipts?
What amount of time does each individual spend at the business?

Names of Managers	Day in	Time in	How long with restaurant	What location	Duties

Who else has managerial control over the employees at the restaurant?

Sales

What types of reports are prepared for the business, and who prepares them? (tip reports; cost of goods reports, daily sales reports, weekly, monthly, etc.) Explain flow from server to monthly statements. What type of system is used for server to make order to kitchen?

1. Sales by menu item: What sells the most? Is there a Daily special?
2. How are orders taken: Guess Checks/Manual? Pre-Numbered?

   Computerized Guess Checks? If manual, what is used to take the order?
   Request to see what is used.
3. Who rings up the sales in the restaurant?

Internal Controls - Sales

Is there a register tape?
Does the manager look at the register tape and sales receipts?
What type of payment is accepted? (cash only, credit cards, checks)
What credit cards are accepted? (VISA, Master Charge, American Express, Diners, etc.)
Estimate Percentage:
Credit card? Checks? Cash? Complimentary? Banquet?

Do you have any special pricing days?
Is there a set fee for banquets or is the charge determined on an individual basis? How do you record the banquets? Where are they on the income statement?
Is liquor sold? What kind? Beer, wine, hard liquor?
How is liquor sold? By food servers? Bartender?
Who records the alcohol sales? Server? Cashier? Bartender?
Do employees receive a discount on menu items? What?
Are waitpersons required to pay for customers who leave without paying?
Are internal controls tested for theft by conducting shift cost of goods sold test?

Internal Controls - Cash

1. How are sales by the waiter staff controlled?
2. How do customers pay for their meals? (Do they pay the waitperson or pay on the way out?)
3. Are pre-numbered meal tickets used for each customer and/or table?
4. If so, how are they issued to each server?
5. What is each server's responsibility for the numbered meal tickets?
6. What happens to void meal tickets?
7. Does someone in management verify voided tickets?
8. Are cash registers used for the restaurant and/or bar?
9. Where are they maintained?
10. Are they pre-set for the individual menu or drink items?
11. Who has access to the cash register?
12. Are cash register drawers closed after each sale?
13. Do the cash registers print sales tickets?
14. How are overrings handled?
15. Are sales tickets given to the customers?
16. Is access to the register tapes restricted? To whom?
17. Are the registers closed out at the end of each shift? By whom?
18. Are beginning and ending cash register transaction numbers compared?
19. If two or more servers and/or hostesses, etc. work simultaneously, do they use the same or different cash registers?
20. Are cash register readings taken during each cashier's shift?
21. Is the cash reconciled to the register tapes and deposited in the bank intact. If so, at what intervals and by whom? What happens to short and over differences?
22. How are expenses for the business paid?
23. Are any expenses paid in cash? If so, are these amounts accounted for?
24. What types of controls are placed on the cash?

25. Who has access to the cash receipts?
26. Who has access to "Z" tapes? Have any "Z" tapes been erased?

Customer Capacity of the Restaurant/Sales?

1. What is the average number of dinners sold on the weekdays and weekends?
2. What is the average cost of a meal?
3. Who determines the price of the meal?
4. How many checks on the average are written per table?
5. Sales by time period: Lunch/ Weekdays? Dinner/Week days? Weekends?
6. What is lowest meal cost per person?
7. What is average cost per person?
8. Seat turnover? Number of seats? Number of tables?
   Number of seats at a table?
9. Square footage? Restaurant area? Beverage area?

(*Observation of the business should be done before interview or examiner needs to conduct interview at business location. A tour of the business may eliminate the need to ask some questions which may be answered during the tour.*)

Employees

1. What is the average number of employees on the payroll?
2. How many employees are part-time?
3. What is the employee turnover?
4. Number of shifts?
5. Average number of employees on each shift?
   a. Captains b. Waitpersons c. Buspersons d. Other
6. Do employees work the same shift on a regular basis?
7. If not, how are shifts rotated?
8. How are different shifts recorded?
9. What type of hours do the employees work - day, afternoon, evening, etc?
10. How are employees paid - weekly, biweekly, and monthly?
11. Are any individuals working at the restaurant considered independent contractors?
12. How is time kept for the employees - sign-in, time clock?
13. What types of side duties, if any, do the employees have on a daily, weekly, or monthly basis? How many people are working on an average day, afternoon, or night shifts for the various areas/positions/shifts of the restaurant? Peak Season - Months?

<u>Tip Income</u> ***(Note: Questions about tips are necessary in order to tie down cash and determine the internal controls for all income and cash transactions. You cannot determine how much cash is deposited daily in the bank until tip cash payments are determined. These questions are asked as part of an income probe and not as part of an employment tax examination.)***

1. Who calculates tips for each server?
2. Are tips pooled and split among waitpersons?
3. What type of records is maintained by the employer for tip Income? By the employee?
4. How are tips split?
   If tips are not split, to whom, and at what percent are they tipped out?
5. How do the employees receive their charge tips?
6. Does the average cash customer tip better or worse than the average charge customer? If so, by how much?
7. Do customers tip differently according to the time they eat?
8. Are there any unusual factors that affect tipping in your establishment?
   Estimate Percentage of Tips: Credit Card? Cash?
9. Other Comments:

<u>Inventory/Cost of Goods Sold</u>

1. When are the purchases recorded? (daily, weekly, etc.)
2. What types of records are maintained when stock is removed from the stockroom?
3. Who is responsible for making the purchases? How do they determine what to order?
4. Are the purchases recorded from checks or invoices?
5. What types of records are available for purchases? (Purchase Journal?)
6. Are the purchase invoices reconciled to the actual inventory?
7. Are purchase discounts available? Were they taken?
8. Do the suppliers offer kickbacks or rebates? How are they recorded?
9. Who has access to the stockroom?
10. Do you compute spoilage?
11. What intervals are physical inventories of merchandise taken and who is responsible for it?
12. Is a calculation done of beginning food inventory plus stockroom withdrawals less ending inventory periodically extended to retail prices and compared to receipts?
13. Estimated food cost percent on purchases is?
    Purchases/Percent = likely Sales
14. Who checks incoming inventory for the kitchen?
15. Are incoming shipments weighed?
16. Once the incoming inventory has been accounted for, what happens to the receiving document?
17. Do the employees eat on the premises?
18. Are they given the meals at a discount?

19. Do the owners/shareholders and/or family members eat at the restaurant? How are these meals recorded? Is cost of goods sold reduced?
20. Are written records maintained for complimentary and employee consumed meals and drinks? How is it booked?
21. Who are the primary suppliers of the business? What do they supply?
22. Turn around time on purchases:

	Turn around Time	Cost/units/oz.	Oz. in drink	Supplier/Vendor
Draft				
Beer				
Wine				
Soda				
Meat				
Produce				
Other				

23. How many glasses of wine are served from each bottle?
24. What is the normal mark-up on mixed drinks? Beer? Wine? Wine coolers?

Other Information

1. Who determines the prices of the meals offered?
2. How are portions controlled?
3. Do you have valet parking?
4. Is there music on premises? Cover charge?
5. What type of advertising is used?
6. Are there any promotions used?
7. Do suppliers pay rebates?
8. Are there any coin-operated machines in the restaurant/bar?
9. What is the age and condition of the equipment?
10. Questions related to any specific expense items on the return (charitable contributions, amortization of goodwill, etc.).
11. Questions related to any specific credits taken on the return.

(Note: Set aside time after the interview to summarize important points from your interview notes. Ask the taxpayer review these summaries and make any changes he or she believes are appropriate. Then, ask the taxpayer to sign or initial the interview summary. This will clarify any misunderstandings regarding what was said during the interview and, if the case is transferred, the next examiner will not have to re-interview the taxpayer.)

This page left intentionally blank.

CHAPTER 4

PROFIT AND LOSS STATEMENT

EXAMINATION OF THE PROFIT AND LOSS STATEMENT

Auditing the profit or loss statement may be the quickest and easiest way to perform an audit of a bar or restaurant. One limitation of this approach may be in examining the gross receipts of the establishment. Since many bars and restaurants deal largely in cash, you will need to determine if the internal controls in place are adequate to ensure that the cash is being deposited into the bank accounts. Because of this uncertainty, an indirect method in addition to a bank deposit analysis may be warranted.

Since bars and restaurants engage in a large volume of transactions and many employees handle cash sales and cash tips, it is imperative that an adequate income probe be conducted for possible unreported income. The initial interview will help the examiner determine if the bar or restaurant has adequate internal controls. The examiner should follow up the interview with tests of those internal controls to determine if the books and records can be relied upon.

MINIMUM INCOME PROBES

- IRM 4.10.4, Audit Technique Handbook, provides an in-depth discussion relating to the proper steps and procedures in conducting income probes.
- IRM 4.10.4.3.3 discusses the minimum income probes for individual "business" returns.
- IRM 4.10.4.3.4 discusses the minimum income probes for corporations and other "business" returns.

It is important that the procedures outlined in the IRM be followed. The purpose of the minimum income probe is to help the agent decide whether to limit the income probe to the minimum steps or to pursue a more in-depth examination of income. (See IRM 4.10.4.4.)

Briefly, minimum income probes are:

1. Form 1040: Business Return:
    a. Prepare preliminary cash "T".
    b. Interview the taxpayer and/or representative.
    c. Conduct a tour of the business during operating hours.
    d. Evaluate and test the existing internal controls.
    e. Reconcile gross receipts per return to books and records.

f. Reconcile the bank deposits back to the books and tax returns for both personal and business bank records.
g. Pre-exam analysis – 3 year comparative analysis
h. Comparison of gross sales on the State sales tax returns and the Federal income tax return.

2. Corporations and other "business" returns:

   a. Pre-exam analysis - 3 year Comparative analysis
   b. Obtain copies of related returns and analyze
   c. Conduct tour of business during operating hours
   d. Interview taxpayer owner and/or corporate officer and/or representative
   e. Evaluate and test the existing internal controls
   f. Reconcile Schedule M-1 and M-2 to return and books and records
   g. Analyze significant balance sheet accounts that lend themselves to reclassification of income
   h. Compare Adjusting Trial Balance to the Balance Sheet and analyze adjusting journal entries for large or unusual items
   i. Reconcile the bank deposits back to the books and tax returns
   j. Comparison of gross sales on the State sales tax returns and the Federal income tax return.

The internal control system needs to be tested for compliance with the taxpayer's (or representative's) description. If you determine that the taxpayer's books are reliable, the examination of income can include direct testing of the books and records. Examples of audit procedures using books and records include:

1. Tracing specific items to receipts,
2. Testing sample receipts to books and records,
3. Applying taxpayer's mark-up to expenditures per records,
4. Testing sample client accounts to receipts,
5. Analyzing adjusting journal entries and differences between books and the tax return.

Remember that these are minimum income probes that must be performed. If the results show the existence of potentially unreported income due to a significant imbalance in the Cash-T, excess unexplained bank deposits or inadequate internal controls, then a more in-depth examination of income is warranted. Those additional probes may include other indirect methods, specific identification methods, and third party verifications.

Note that the IRM states that "[i]f it is determined that the taxpayer's books are not reliable, the examination of income should include indirect analysis." (IRM 4.10.3.4.6.2.) Thus, when a taxpayer does not keep adequate books and records, serious consideration should be given to an appropriate in-depth indirect method in the income probe. In a restaurant many employees are trusted to handle cash.

Proper internal controls are normally not in place, especially when the bar or restaurant has no point-of-sales system that requires that all transactions be recorded. Internal controls can also be lacking in a system in which the controls designed for the point-of-sales system are not implemented such as the recording of cash tips. This means that all of the cash received from customers is not accounted for and correct income is not reported. Usually in a bar, one person (for example, the bartender) may be handling all of the cash transactions including balancing out the tills each day. This lack of separation of duties essential to a system of controls necessitates extending the income probe beyond the minimum required by the IRM. This determination can normally be made after the initial interview.

ADDITIONAL INCOME PROBES AND INDIRECT METHODS ─ IRM 4.10.4.6

If additional income probes are needed, consider the use of a full bank deposit analysis, the net worth method, a source and application of funds analysis, or the specific item method. Additional probes usually require the use of third-party contacts and third-party contact procedures need to be followed. (See IRM 4.10.4.5.3.6.) It is necessary to get complete information about non-taxable sources of cash, which may explain any understatements. This is especially true of cash on hand and of cash hoards. (See IRM 4.6.3.8.4.)

Since the bar or restaurant industry is largely a cash-based one, the indirect methods discussed in this section may only show that an understatement of income exists. It may be hard or impossible to detect how the understatement was achieved. For example, the taxpayer may only be reporting income from one cash register when two are used, etc. The only way to possibly uncover this is to ask a lot of questions and keep your eyes open during the tour of the business. Another helpful technique is to visit the operation during its normal business hours and observe how transactions are handled. Additionally, you may find it useful to contact state regulatory agencies such as liquor control boards or gambling operations boards. These state boards routinely send agents to restaurants and bars to sit in on the business operations unannounced and observe the operations. They prepare a report of their observations, which may be available to the IRS examiner.

Specific Items Method of Determining Income ─ IRM 4.10.4.5.2

This method is preferable to an indirect method as it is based upon direct evidence of income. For example, a restaurant owner may receive rebates from a supplier. A copy of the supplier's invoices and cancelled checks establishes the amount of income from these rebates. The specific items method relies on evidence gathered from source documents, rather than estimates. If records cannot be obtained from the taxpayer, you may have to contact third parties. If you do, be certain you correctly follow third party contact procedures. (See IRM 4.10.4.5.3.6.)

The specific items method of establishing income, supplemented by the bank deposit method, is illustrated in ***Ketler v. Commissioner***, T.C. Memo. 1999-68. During 1990 and 1991, Warren Ketler operated two sole proprietorships, including a catering operation doing business as "California Barbecue." Mr. Ketler failed to file Federal income tax returns for 1990 and 1991. The Service determined Mr. Ketler's unreported income for these years by reference to Forms 1099 provided by payers. Prior to trial, the Service obtained 1990 and 1991 bank records for all of Mr. Ketler's accounts and identified various nontaxable transfers and deductible business expenses. Based on this analysis, the Service asked that the Tax Court find increased income tax deficiencies. After trial, the Tax Court found that Mr. Ketler received the income reflected on the Forms 1099. It also found that the Service had properly performed the bank deposits analysis, and, therefore, Mr. Ketler was also liable for increased income tax deficiencies.

Indirect Methods

Consider the use of the following indirect methods:

- Bank deposit analysis ─ IRM 4.10.4.6.3
- Fully developed cash T method ─ IRM 4.10.4.6.4
- Source and application of funds ─ IRM 4.10.4.6.4.4
- Net worth method ─ IRM 4.10.4.6.5
- Percentage of markup method ─ IRM 4.10.4.6.6
- Unit and volume method ─ IRM 4.10.4.6.7

The examiner may need to review the above-referenced IRM sections for the proper application of these methods. If any of these methods rely on estimates, they should be corroborated by other methods to establish a stronger position. When tracing cash through a bank deposit analysis or using the source and application of funds method, several unique facets of bar and restaurant operations should be recognized.

- Cash payouts are not deposited, but the money that comes from making the cash purchases originated from sales. This is cash that would not be deposited into a bank account.
- Cash payment of employee credit card tips is money that is not deposited.
- Sales tax collected from customers for cash sales is money deposited that is not a source of income. In many states the sales tax for restaurants and bars is higher than the sales tax for other retail businesses.
- Cash collected from vending machines is cash that needs to be deposited which is income.
- Credit card payments from credit card companies for sales will include deposits of employee tips plus the sales taxes plus the sale. Only the portion representing the sale is taxable.
- Loans from shareholders are a non-taxable source of cash. Proof of payment is necessary to establish facts.

- Transfers between bank accounts are non-taxable.

The bank deposit analysis method assumes that the bar or restaurant owner deposits all income in a bank account. In a cash-intensive business such as a bar or restaurant, this may not be the case. For that reason, the bank deposits analysis should generally be supplemented with another indirect method when auditing a bar or restaurant.

To further support an indirect method another examination technique may be used such as having the examiner inspect the supply invoices to find the name of the company that prints the guest checks. This printing company can provide the number of guest checks purchased by the restaurant in a year. A projected income can then be determined from the average amount of the guest check times the number of checks. If these methods are used in combination, they strengthen the case.

In examining a bar, it is possible that the bar owner may remove cash from his or her drawer, purchase liquor off the shelf of a store, sell the drinks in his or her establishment and pocket the profits. In such case, there may be no indication in the books that anything is wrong as neither the invoice nor the income touches the books. An indirect method may uncover this.

Bank Deposits Method

The bank deposits method of establishing income is illustrated in ***Ng v. Commissioner***, T.C. Memo. 1997-248. From 1986 through 1990, Big Hong Ng owned interests in several business entities, including various restaurants. Ms. Ng controlled several bank accounts in the United States and Hong Kong. She commingled her personal funds with those of the business entities in which she had an interest. The Service conducted a bank deposit analysis and determined that Ms. Ng failed to report significant amounts of taxable income during the years in issue.

In analyzing the bank deposits, the Service separated cash, checks, cashier's checks and wire transfers. It examined the source of each deposit and separated items subject to self-employment tax from those not subject to such tax. Further, to the extent possible, the Service eliminated those items that had been reported on Ms. Ng's income tax returns or that came from nontaxable sources (for example, transfers and refinancing proceeds). The Service also analyzed Ms. Ng's cash expenditures. The expenditures that could not be traced to a nontaxable source or reported income were considered unreported income.

The Court largely agreed with the Service's determination of unreported income, but found that Ms. Ng. had only a limited interest in the funds in certain bank accounts. Accordingly, the Court reduced the amount of unreported income determined by the Service.

Net Worth Method

The net worth method of establishing income is illustrated in ***Michas v. Commissioner***, T.C. Memo. 1992-161. During 1984, the taxpayers owned several sole-proprietorships, including a liquor store. The Service determined that the books and records of these sole-proprietorships were inadequate and analyzed the taxpayers' net worth to determine whether all taxable income had been reported. The Service performed this analysis by determining the cost of the taxpayers' business and personal assets at the beginning and end of 1984. The Service then reduced these amounts by the taxpayers' liabilities at the beginning and end of the year. Then, the difference was adjusted by adding nondeductible expenditures (for example, living expenses) and by subtracting nontaxable sources of income (for example, gifts and loans).

The Court largely agreed with the Service, but found that certain adjustments to net worth were not proper. Accordingly, the Court reduced the amount of unreported income determined by the Service.

Percentage Markup Method of Determining Income (IRM 4.10.4.6.6)

IRM 4.10.4.6.6.2 states that the percentage markup method is recommended in the following situations:

1. When inventories are a factor and the taxpayer has nonexistent or inadequate records
2. Where a taxpayer's cost of goods sold or merchandise purchased is from one or two sources and these sources can be ascertained with reasonable certainty and there is a reasonable degree of consistency as to sales prices.

Consider the following when applying the percentage of markup method:

1. Judgment should be exercised by examiners to make sure the comparisons are made to situations that are similar to those under examination
2. The availability of valid sources of information containing the necessary percentages and ratios
3. Complexity of the taxpayer's product mix and the availability of valid percentages and ratios for each product
4. Length of the period covered during the examination and the need to adjust the percentages and ratios to reflect those existing during the examination

Computations in the Percentage of Markup Method

Income from the Sale of Food.

Possible daily volume X Average check per seat = Daily sales

- The possible daily volume would be the number of seats in the establishment X how many times in a day they are occupied. The possible daily volume can be broken down into time periods in a day (breakfast, lunch, or dinner) to get a more accurate tally.

- The average check per seat can be obtained from the taxpayer during the initial interview.

The daily sales can be extended to weekly and yearly sales based on the days open per week and the weeks open per year.

Daily sales X Days open in a week = Weekly sales

Weekly sales X Weeks open in a year = Yearly sales

These estimates should take into account the number of vacant seats and people who walk out before paying their bill. The examiner should also look at the taxpayer's advertising account to test the accuracy of reported income. Are specials advertised? How often? Specials may refer to certain menu items or discounted prices or both. Are the times during which specials are offered (for example, happy hour or weekly breakfast hours) reflected in the daily receipts ledger? During the initial interview ask enough pertinent questions to determine if these or any other situations should be considered.

In addition to the above calculations, normal audit procedures should be followed, including tracing gross receipts to bank deposits, analyzing bank deposits of all business and personal accounts of the owner/manager, etc. Review the interview responses regarding internal controls. Does the same person who counts the daily receipts also make the bank deposit? Are the meal orders taken on numbered tickets or would it be easy to simply not ring up a sale on the cash register for some orders? The examiner must look closely at the supervision habits in the restaurant to evaluate how sales might be understated or how easily theft may occur and by whom.

Income From The Bar.

As in any income tax examination, the auditing techniques used depend on the quality and quantity of the taxpayer's books and records. If the taxpayer is a large bar that maintains inventory records which detail the daily and/or monthly purchases and sales of liquor, then the liquor cost percentage can be computed and applied to total purchases to determine the gross receipts and gross profit of the taxpayer. If the taxpayer is a small "Mom and Pop" bar that does not maintain detailed purchase and sale records, it may be difficult and time consuming to compute its purchases for one day or one month. In this case, it may be preferable to rely (at least in part) on third party information to verify purchases and compute the mark-up on cost. The mark-up may then be applied to total purchases of similar items to approximate the taxpayer's gross receipts and gross profit.

Using the Liquor Cost Percentage to Compute Gross Receipts.

To compute gross receipts using the liquor cost percentage, the following steps should be taken:

a. Determine the cost of some of the more popular brands of liquor
b. Determine the sales values of the bottle if all liquor out of these bottles were sold
c. Divide the sales value into the cost to get the potential pouring cost

Example 1
Computing the liquor cost percentage:

a. Determine the cost of liquor:
The taxpayer's records and verification from third party sources indicate that the cost per quart is $4.48.
b. Determine the sales value of the bottle:
A quart has 32 ounces in it. If the taxpayer poured 1-1/4 ounces per drink, there would be 25.60 drinks per bottle. (32/1.25 = 25.60)

If the taxpayer sold the drinks for $1.10, then the sales value per bottle less sales tax of $1.97 would be $26.19. (25.60 X $1.10 = $28.16 -$1.97 = $26.19)

c. Determine the pouring cost percent:

Cost per bottle/Sales value = Pouring cost %

This gives you the potential pouring cost percent.

$$\frac{\text{Cost}}{\text{Sales value}} \quad \frac{\$4.48}{\$26.19} = 17.1\ \%$$

d. Determine the gross sales:

Purchases/Pouring cost % = Gross sales

If 17.1 percent is applied to total purchases of $5,000, the gross receipts should be $29,239.77 or ($5,000/17.1% = $29,239.77).

Gross Receipts (100%)	$29,239.77
Less: Purchases (17.1%)	($ 5,000.00)
Gross Profit (82.9%)	$24,239.77

***NOTE**: Using the formula discussed above, the computations could be used to calculate the total sales value of all bottles sold in a week or a month, etc. Consider a factor for waste and spoilage of about 5% to 8 %. Also, subtract out the sales tax from the cost.*

Using the Mark-up on Cost Method to compute the Gross Receipts.

If it is difficult to determine a taxpayer's daily and/or monthly purchases, the Mark-up on Cost Method may be used to compute gross receipts and gross profit. This method works closely with the liquor cost percentage method, however, different percentages are being determined.

As with the cost percentage method, the cost and sales value of the various items needs to be computed. Then, the mark-up on cost can be computed. Mark-up on cost is the amount of the sales price over the cost of an item.

Example 2

Simplified

Sales Price	10.00
Cost	5.00
Goss Profit	5.00

Mark-Up on Cost = Sales price/Cost
$10.00/$5.00 = 200%

The following steps should be taken to compute gross receipts based on mark-up on cost:

a. Determine the mark-up of the various alcoholic items the taxpayer sells. The mark-up should be determined, if possible, in the initial interview. If the taxpayer does not know the mark-up of the bar items, you must compute it based on the sales price of drinks and the cost of the drinks.
b. Determine the purchases made by the taxpayer. You can obtain this information from the invoices provided by the taxpayer, if available and accurate. If accurate records are not available, you should request the names of all of the vendors from the taxpayer in the initial interview. Following third-party contact procedures, send letters to the vendors requesting all records of purchases made by the taxpayer in the years under examination or contact other available sources.
c. Apply the mark-up to the purchases of the various types of alcohol. As in the earlier simplified example:

Cost x Mark-up = Projected sales price

Mark-up = 200%
Cost = $ 5.00
Sales Price = $10.00
($5.00 X 200% = $10.00 Projected sales price)

The steps discussed above do not take into account amounts for spillage, happy hour prices, etc. This information must be determined in the initial interview so that the taxpayer can be allowed these amounts in determining the correct gross receipts.

Sales price per drink/Cost per drink/ mark-up of drink

<u>Computing the mark-ups on the various types of drinks.</u>

1. <u>Alcoholic Drinks</u>
   Sales Price per Drink -- Take the average of the more popular drinks served in the bar as stated by the taxpayer in the initial interview. It is important to determine in the initial interview the amount of alcohol in each drink.

   Cost per drink = Bottle price / Number of drinks in bottle

   The bottle price is an average price of alcohol based on information from your local liquor dispensary.

2. <u>Draft Beer</u>
   Sales price is based on the price of the beer per the taxpayer in the initial interview. Divide the sales price by the size of the drink to get the sales price per ounce. It is important to determine the size of beers served, ounces in each glass, pitcher, etc.

   Cost of the beer is an average cost of beer available for sale by the taxpayer, sold in kegs, divided by the number of ounces in a keg (1,984 ounces). This gives the cost per ounce.

3. <u>Bottled/ Canned Beer</u>
   Sales price of the bottled/canned beer is based on the price for the bottle or can per the taxpayer in the initial interview.

   Cost of the beer is an average cost of beers available for sale by the taxpayer. Bottles and cans are usually sold by 12-pack or case (24), therefore, divide the cost by 12 or 24.

4. Wine
   Sales price per glass is based on the price per the taxpayer in the initial interview. Divide the sales price by the size of the glass to get sales price per ounce. It is important to determine in initial interview the ounces in each serving.

   Cost of the wine is an average cost of wine available for sale by the taxpayer. Wine can be sold by the bottle, box, or keg, therefore, take the cost of the unit divided by the number of ounces to get a cost per ounce.

5. Wine Coolers
   Sales price by the bottle is based on the price per the taxpayer in the initial interview. Cost of the bottle is an average cost of wine available for sale by the taxpayer. Wine coolers are usually sold in case lots of 24. Divide the cost by 24 to get the cost per the bottle.

Court Cases On Percent of Markup Method

The percent of markup method of establishing income is illustrated in ***Cebollero v. Commissioner***, T.C. Memo. 1990-618, ***aff'd***, 967 F.2d 986 (4th Cir. 1992). During 1982, 1983 and 1984, Manuel Cebollero owned a retail liquor store in partnership with his former wife. During the audit, the Service was unable to confirm the percentage mark-ups provided by Mr. Cebollero. Therefore, the Service verified the prices on Mr. Cebollero's price list and his cost of goods sold. The Service computed Mr. Cebollero's mark-up figures by dividing the sales price for each item on the price list by its cost. The Service made no adjustment for sales or discounts. This computation revealed that Mr. Cebollero's mark-up was exactly what he said it was. It also revealed a large understatement of gross income.

The Court largely agreed with the Service, but allowed an adjustment for items sold at sale prices. Accordingly, the Court reduced the amount of unreported income determined by the Service.

Employee Tip Income ─ Reconstruction Using Indirect Methods

Employee tip income is income under IRC section 61 and Treas. Reg. section 1.61-2(a)(1) and can be reconstructed using indirect methods. The percentage markup method is one of the most often used methods to reconstruct unreported tips, although the cash expenditures method is also used. The McQuatters formula is also a common method to determine the tips as an hourly amount, a percentage of gross sales or receipts, or a percentage of the taxpayer's wages.

The McQuatters formula is illustrated in the case from which it gets its name, ***McQuatters, et. al. v. Commissioner***, T.C. Memo. 1973-240. During 1967 and 1968, Lorna McQuatters was employed as a waitress at the Space Needle Restaurant. Ms. McQuatters kept no records of her tip income for these years. Therefore, the Service determined her tip income indirectly by the following method: (1) total sales of food and beverages reduced by 10 percent to allow for low or nontippers and tip-sharing; (2) this amount (that is, sales subject to tips) was divided by the total number of hours worked by all waitresses during the year to arrive at sales-per-waitress-per-hour average; (3) this average was multiplied by the number of hours in each year that Ms. McQuatters worked to determine her yearly sales; and (4) her yearly sales were multiplied by 12 percent to compute her yearly tip income.

The Court reduced the tip income percentage from twelve percent to ten percent. Otherwise, because Ms. McQuatters kept no records of her tip income, the Court upheld the Service's determination.

(Note: Extending the income tax examination of the restaurant to include employee examinations should be coordinated with the employment tax group. If you believe an employee examination is warranted, contact your Area employment tax group or make a referral.)

OTHER INCOME

Income from Coin-Operated Activities

Coin-operated machines located in bars or restaurants constitute another important source of income. Coin-operated machines may include jukeboxes, cigarette machines, pool tables, dart boards, video games, etc. These machines can be owned by the taxpayer or leased from another party. If the machines are leased, the general rule is that the income generated from the machines is split based on some percentage determined by the owner of the machine.

Income generated from coin-operated activities is very difficult to determine accurately. Therefore, it is important to ask a lot of pertinent questions in the initial interview regarding the operation and income generated by these machines. It may be necessary to secure third party information to compute this income. Additionally, it may be helpful to check Internet resources including the Small Business Administration. Many vending machine companies also have information regarding average annual sales per machines.

Other Sources of Income Activities

- Lottery tickets
- Gaming pools
- Vending Machines
- Franchise Rebate Income
- Tenant/Fixture Allowance
- Supplier or Advertising Rebates/Incentives/Reimbursement
- Sales of assets
- Cover charges for admissions

- Selling concessions at sporting events/banquets/high schools
- Renting out rooms for weddings and birthdays, etc.
- Catering
- Banquets
- Bartering
- Related party transactions
- Kickback from vendors
- Renting space for signs and video machines

These possible sources of income should be considered during the initial interview. Ask pertinent questions to determine if the taxpayer engages in these activities and how the cash is handled and reported on the tax return.

Rebates from Supplies

Treatment of Upfront Payment to Restaurant Owners from Suppliers under Supplier Agreements

It is common practice in the restaurant industry for suppliers to enter into supplier arrangements with restaurants. Typically, these arrangements extend beyond the taxable year. For example, suppose that Supplier A enters into an agreement with a restaurant chain to supply soft drink concentrate. The contract states that the supplier will advance $5,000,000 to the restaurant chain immediately and in return the restaurant agrees to purchase all of its soft drinks from Supplier A for the next 5 years. The Service's position is that upfront payments received under supplier agreements are income upon receipt.

This page left intentionally blank.

CHAPTER 5

AUDIT ISSUES AND TECHNIQUES – EXPENSES

COST OF GOODS SOLD

Purchases

IRM 4.10.3.10. Costs of goods sold can be one of the largest expenses on the return. The examiner should be aware that the purchase figure reported on the return might be a "plug" figure in order to balance the cost of goods sold computation. IRM Handbook 7.8.1.1.6.5.1 outlines minimum checks for purchases:

- Scan purchases column in the cash disbursements journal, voucher register, etc. and look for items unusual in amount and to vendors not generally associated with the products or services handled by the taxpayer.

- Review entries in the general ledger control account. Note and verify entries which originate from other than usual sources (general ledger) entries, debit and credit memos, etc.

- Test check the recorded purchases for a representative period with vendor's invoices and cancelled checks, etc. Be alert to such items as: (a) personal items (b) capital expenditures (clothing, boats, furniture, etc.).

- Compare inventory balances in the return under examination with the balances for the prior and subsequent years' returns, and verify these with the organization's records

Inventory

IRM 4.10.3.8.4.3 – prior to Revenue Procedures 2000-22, 2000-20 IRB 1008, and 2001-10, 2001-3 IRB 309, restaurants with inventory were required to use the accrual method of accounting. For taxable years ending on or after December 17, 2000, restaurants with less than $1,000,000 in average gross receipts that make a proper election can expense inventory.

Spoilage or theft is usually reflected in inventory, and is not an operating expense.

Other Issues involving Cost of Goods Sold

- Treatment of coupons
- Gift certificates

- Charitable contributions of food (be sure the deduction is not being double deducted once in cost of goods sold and again as a charitable deduction.
- Employee meals
- Personal consumption of food/alcohol by owners

OTHER EXPENSE ISSUES

Package Design Costs

Food companies incur significant costs in developing designs for their products. The Internal Revenue Service has issued guidance in the form of a coordinated issue paper and several Revenue Procedures (including Revenue Procedures 97-37, 1997-2 C.B.455, and 98-39, 1998-1 C.B. 1320) and Revenue Ruling 89-23, 1989-1 C.B. 85, stating that these costs are capital in nature and, depending upon the election a taxpayer makes, recoverable over a 4 or 5-year period. The issue was litigated. (***RJR Nabisco, Inc., v Commissioner***, T.C. Memo. 1998-252). The taxpayers took the position that package design costs are merely a form of advertising and currently deductible. The Internal Revenue Service argued that the costs produces long-term benefits and that these costs are capital in nature and must be capitalized. The Court ruled in favor of the taxpayer. An Action on Decision has been issued stating that the Service will not follow this decision and will continue to litigate this issue. Many taxpayers have filed Form 3115 requesting a change in accounting method from the capitalization of package design costs to the expense of those costs. The IRS is denying these requests.

Charitable Contributions of Food Inventory

IRC section 170(e)(3) allows an enhanced deduction for qualifying contributions of food inventory. This deduction is equal to the basis of the property contributed plus one half of the appreciation, not to exceed twice the basis. The amount would be treated as a contribution and cost of goods sold would be reduced by the amount of the contribution. Congressional intent behind this code section is to encourage charitable contributions of excess inventory. Problems encountered during examination include:

1. Taxpayers taking enhanced deductions but not reducing the cost of goods sold by the basis of the property resulting in a double deduction.
2. Contributions made to an organization that is not a qualifying organization.
3. Determining the fair market value of donated food. What is the FMV of 3-day-old bread? Is it the same value as 1-day-old bread? If the market value is zero, there is no deduction. This is the area of greatest dispute. ISP settlement guidelines have been published with respect to this issue.

Depreciable Life of a Restaurant's Smallwares Asset Account

On January 7, 2002, the Service issued guidance (Rev. Proc. 2002-12) on a safe harbor method of accounting for the cost of smallwares. Generally, most smallwares will be deductible. The Revenue Procedure will apply to acquisition costs of smallwares incurred by taxpayers currently engaged in the trade or business of operating a bar or restaurant. Acquisition costs of smallwares that are start-up expenses will still be subject to IRC section 195. The revenue procedure will apply to bars and restaurants that fall under NAICS code 722. Rather than capitalizing the cost of smallwares, taxpayers will be allowed to deduct them under Treas. Reg. section 1.162-3 as non-incidental materials and supplies when they are received at the restaurant and are available for use.

When a full service restaurant opens a location, they will purchase $50,000 to $70,000 worth of smallwares (glassware, china, silverware, linen and small kitchen tools). An issue was identified relating to the recovery period of these assets and how to treat the replacement costs of these items. Typically, restaurant equipment costs are recovered over 5 years, but the smallwares used by a restaurant have different characteristics and turnover rate studies show that collectively, the initial cost of the smallware asset account is absorbed within 16-20 months. As of the recent Revenue Procedure most smallwares will be deductible.

Amortization of Goodwill and Covenants-not-to-compete

Goodwill is amortized under IRC section 197 over a 15-year period of time. Restaurant sales agreements often fail to properly allocate goodwill. Goodwill is often not given a monetary value when a restaurant is sold. Instead, the value may be given to the other assets with shorter depreciable lives. If the valuation of the assets appears to be tax motivated, and not based upon the correct value of the assets in issue, consider a referral to the Engineer Group for assistance to determine the proper fair market value of the assets sold and/or purchased.

Treatment of Liquor License Costs

Liquor license costs were previously treated as intangible assets with an indeterminate life and no recovery was allowed until sold. Under IRC section 197, liquor license costs can now be amortized over 15 years. Audit issues would include determining the cost of the liquor license in a purchase sale agreement or through an application process with the license control board.

Treatment of Franchise Costs

Franchise costs are amortized over 15 years under IRC section 197. Audit issue is to determine the proper valuation of the franchise costs.

Depreciation of Restaurant Buildings

The useful life of the bar or restaurant building and any improvements is 39 years. The examiner should identify separate structural and non-structural improvements and make certain that these improvements are treated correctly for tax purposes. Note: The NRA would like to change the useful life of restaurant buildings to 5 years for the original structure and 7 years for improvements based on the rationale that the average restaurant changes its décor every 6 to 8 years.

SALE OF A RESTAURANT ─ INCOME ISSUES

Losses Incurred when a Restaurant Closes

In the restaurant industry, approximately 80 percent of all new restaurants go out of business within 2 to 3 years. Is a taxpayer entitled to deduct the difference between the adjusted basis of the property and its appraised value when a location is closed but not disposed of? Some taxpayers are taking the position that when the restaurant closes and the building is owned, they are entitled to a loss in the form of bonus depreciation equal to the difference between the adjusted basis in the building and its appraised value. The NRA has been working with the Service to determine the correct tax treatment under these circumstances. The Service has taken the position that a loss on IRC section 1250 property is not permitted until the property has been disposed of or abandoned. The closing of a restaurant does not constitute a disposition or abandonment.

Capital Gains on Sale of Business

Be aware that IRC section 1231 provides that a net gain on the sale of a trade or business with depreciable assets is capital in nature and a net loss on the sale of business assets is ordinary in nature. Check for the proper calculation of assets' cost basis, depreciation taken, and actual sales price. Confirm that inventory was not included in computing capital gain on the sale of a trade or business as the sale of inventory is ordinary income.

Ordinary Income/Loss on Sale of Business

Sale of inventory and accounts receivable require ordinary income recognition. See IRC section 1221(a)(1). Determine what assets were sold, that is, capital assets or inventory. Check financial statements provided to third parties for balance sheet breakdown.

Income from Discharge of Indebtedness or IRC section 108 Reductions for Tax Attributes

Loans between a corporation and shareholders that remain unpaid at the time the business ceases operations, may result in cancellation of indebtedness income to the borrower under IRC section 61(a)(12). Other debts to outside creditors that remain unpaid may represent possible income to the debtor in the form of debt relief. If the income is not recognized under IRC section 108 due to bankruptcy or insolvency, tax attributes must be reduced by the amount of the cancelled debt. Note that if the taxpayer is an S corporation, a discharge of its indebtedness is an income item that passes through to its shareholders and increases their basis in its stock. (See ***Gitlitz v. Commissioner***, 531 U.S. 206 (2001).)

Taxable Liquidating Distributions to Shareholders

If assets are redistributed to shareholders when a corporation ceases operations, the shareholders or the corporation may have to recognize capital gain on the distribution. See IRC sections 331(a) and 1001(a).

Unused Carryovers, Credits, Recapture Issues

Other issues involve the loss of unused carryovers of net operating losses, credits, and/or recapture issues.

- Recapture of business tax credits (Indian Employment Credit, investment credit, etc.).
- Deduction of certain unused business tax credits. Generally unused credits are allowed in the final year of operations, but not for research credit and investment credit and some other credits.
- Other unused tax credit carryovers not lost are prior year minimum tax credit carryovers, foreign tax credits, credit for federal tax on fuels, and non-conventional source fuel credit.
- Recapture of depreciation or amortization. An early disposition of property may require recapture of IRC section 179 depreciation and some amortization expenses. See IRC sections 1245 and 1250.
- Depreciation deduction in the year of disposition. Under MACRS depreciation is allowed in the year of disposition for part of the year, but not the whole year.
- Deduction of intangibles in the year of disposition. Gain or loss on the sale or exchange of amortizable intangible property is an IRC section 1231 gain or loss. IRC section 197 intangibles acquired before August 10, 1993 are written off in full in the year of disposition.
- Remaining start-up costs not previously amortized may be deducted in the year of disposition.
- Suspended passive activity losses are written off in the final year of operations.

- There is a 20-year carryforward period of limitation on net operating loss deductions. Unused net operating loss carryovers for a regular C corporation are lost in the final year of operation.
- Unused charitable contribution carryovers are not deductible in the final year of disposition on a corporation.

CREDITS

Credit for Taxes Paid on Certain Employee Tips

(Form 8846) also known as FICA Tax Deduction/Credit ─ IRC section 45B ─ This credit is generally equal to the employer's share of Social Security and Medicare Tax (FICA) paid on tips received by employees on food and beverage establishments. The credit applies whether food is consumed on or off the business premises. No credit is given for the tips used to meet the Federal Minimum Wage Rate under the Fair Labor Standards Act. If the credit is taken, the employer must reduce the deduction by the credit taken.

Work Opportunity Tax Credit (WOTC)

(Form 5884) ─ IRC sections 51, 52, and 280C. In 1996 the federal welfare reform law required states take more people off of welfare and put them into the workforce. Congress provided the Work Opportunity Tax Credit that gives employers up to $2,400 tax credit per year against the wages of certain disadvantaged workers, including former welfare recipients. This credit expired December 31, 2001. It is expected to be retroactively reinstated. Please check your local research center. There is a bill before Congress to make this credit permanent. Per the NRA statistics, one in four restaurants have used the WOTC to hire disadvantaged individuals. Nearly 75 percent of quick service restaurants have hired a former welfare recipient.

Welfare to Work Credit

(Form 8861) ─ Under IRC section 51A, this credit provides businesses with an incentive to hire long-term family assistance recipients.

Disabled Access Credit

(Form 8826) ─ Under IRC section 44, the disabled access credit is a nonrefundable tax credit for an eligible small business that pays or incurs expenses to provide access to persons who have disabilities. The expenses must be incurred to comply with the Americans with Disabilities Act of 1990.

Empowerment Zone Credit

(Form 8844) ─ Under IRC section 1396, this credit is for employers who have employees and are engaged in a business in an empowerment zone for which the credit is available.

Energy Credit

(Form 3468) ─ Under IRC section 48, this credit applies to certain expenses for solar and geothermal energy property you place in service during the tax year.

Rehabilitation Credit

(Form 3468) ─ Under IRC section 47, this credit applies to expenses the business incurs to rehabilitate certain buildings.

Enterprise Zone Credit

IRC section 1394. An enterprise zone business may be eligible for interest free bonds for operating a business in an enterprise zone. Eight criteria must be satisfied to be an enterprise zone business. These criteria include conducting a business within the an enterprise community, and having at least 50 percent of the business gross receipts must be from a business activity within the enterprise zone community, and having a substantial portion of the business property and employee services be within the zone. At least 35 percent of the employees must be residents of the enterprise zone community.

Research Credit

(Form 6765) ─ Under IRC section 41, the research credit is designed to encourage businesses to increase the amounts they spend on research and experimental activities. The credit is generally 20 percent of the amount by which research expenditures exceed the base amount.

This page left intentionally blank.

CHAPTER 6

AUDIT ISSUES AND TECHNIQUES – BALANCE SHEET

EXAMINING BALANCE SHEET ACCOUNTS

An examination of the balance sheet can be advantageous to detect certain issues that might not be detected with just an examination of the income statement. It is essential to a proper income probe of a cash intensive business to trace the management of cash back to its source documentation.

Audit Techniques for Examining Balance Sheet Accounts

1. Perform a comparative balance sheet analysis. Generally, a minimum of 3 years will be involved, the assigned year and the prior and subsequent years. These 3 years will provide 4 years of "end-of-year" balances.

2. Conduct Ratio Analyses by industry standards. (See Appendix 4 for ratios).

NOTE: Not all balance sheet account analyses are included in this package. This does not imply that the other accounts are correct or should not be audited.

CASH ACCOUNT (IRM 4.10.3.8.4.1)

Normal audit procedures should be performed, such as tracing gross receipts to bank deposits, doing a bank deposit analysis of all business bank accounts and if appropriate, the owner/manager's personal bank accounts. It is important to remember that restaurants and bars are cash driven businesses, and that cash can be hard to tie down using a bank deposit analysis if all cash is not deposited. It is important to tie down gross receipts from every source and cash that is paid out as expenditures. The income statement section of this Guide considers several indirect methods for determining income. However, you should also consider the following techniques.

Audit Techniques for Identifying Cash and Unreported Income

1. Obtain the year-end reconciliation and compare it to the taxpayer’s books. Old outstanding checks should be considered for possible inclusion in income. Likewise, the most recently issued outstanding checks should be examined to determine if the taxpayer engages in the practice of drawing checks, but not issuing them promptly. This practice is usually applicable to cash-basis taxpayers. If you believe this practice exists, observe the dates that checks were paid as indicated by the stamp that the bank puts on the cancelled checks. Another way is to look for a credit balance in the cash account indicating checks drawn but not issued until later.

2. Using cancelled checks, test one month's returned checks in the following manner: Compare the name of the payee with that of the endorser. If they do not agree, or if the name of any officer, partner, shareholder, etc. appears as secondary endorser, determine why. The cash disbursement book should be open to the appropriate month while this is being done. If the payees of any checks are the officers, etc., or if the checks are drawn to "bearer" or "cash", look at the cash disbursement journal to see if the payee described therein is the same one named on the check itself.

3. Review the cash disbursements journal for a selected period. Note any missing check numbers and large or unusual items. Determine the propriety of these items by comparing with vouchers and other records.

4. Determine if voided checks have been properly handled.

5. Review the cash receipts journal for items identified as ordinary business sales and be alert for items such as sale of an asset or prepaid income.

6. View entries in the general ledger cash accounts for unusual items that do not originate from the cash receipts or disbursements journal. These entries may indicate unauthorized withdrawals or expenditures, sales of capital assets, or omitted income.

7. Test-check some cash sales with the cash receipts journal to see if cash has been correctly recorded. Check cash sales made at the beginning and end of the period to see if year-end sales have properly been recorded.

8. Test-check cash payouts to see if there are unallowable items. Check to see if sales have been recorded first before cash is paid out.

9. Scrutinize cash overages and shortages, being alert to irregularities that may have cleared accounts.

10. Run tape totals on guest checks to compare to cash register totals. Review cumulative register readings. Compare cash register tape totals to daily operating report.

11. Inspect voided guest checks and see how they have been recorded. Sample.

Stale Checks

Banks are generally not obligated to honor checks that are over 6 months old. If checks are outstanding for a prolonged period of time, the issue of liability should be raised. The taxpayer may no longer be liable for outstanding checks. If there is no expectation that old checks will be cashed and payments made, the amounts of those checks should be restored to income. Alternatively, the expense associated with the outstanding obligations can be reversed and the check should no longer be carried as an outstanding check on the bank reconciliation. In other words, debit cash and credit the expense.

Audit Technique for Verifying Cash, Stale Checks, and Unreported Income

In reconciling the cash account, there will be outstanding checks. Determine what the company policy is for restoring outstanding checks to income. Select all checks over 6 months old and determine whether those checks should be restored to income.

- IRC section 61 defines gross income as all income from whatever source derived.

- IRC section 111 (a) provides that gross income does not include income attributable to recoveries during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce income subject to tax.

Card Credit Sales Versus Cash Sales

During the initial interview, the owner or manager of the bar or restaurant should be questioned regarding the predominant form of payment used by the customers. Those who are involved with the day-to-day operations of the business will have a general idea regarding the breakdown between cash and credit card sales. Then, based on an analysis of the bar or restaurant's bank records, determine the percentage of credit card sales to cash sales. Is this a reasonable percentage for the type of bar or restaurant? Is it consistent with any oral testimony obtained? For example, one would expect a fast food restaurant chain to have little or no credit card sales while a full service restaurant and bar would have greater credit card sales than cash sales. If a restaurant is claiming no cash sales or depositing a small amount of cash, then it becomes important to tie down the true amount of cash and credit card sales. It is also possible for a restaurant to not ring up credit cards sales from a particular credit card company such as Diners, American Express, or any card company. (Note: Employers must report total charged receipts showing charged tips on Form 8027.)

Audit Techniques for Verifying Cash and Credit Card Sales

1. Reconcile the total credit card sales shown on Form 8027 to the Daily Cash Reports Year-end Summary. Reconcile this to the year-end summary of credit card sales from the cash register tapes.

2. Reconcile the credit card bank statements to both Form 8027 and the year-end book summaries of credit card sales from the cash register tapes.

3. Notice what credit cards the restaurant accepts posted on the outside windows or near the cash register machines during the tour of the business.

Specifically ask the restaurant owner and/or manager which credit cards are accepted from customers during the initial interview. Inspect the actual bank statements of each of these credit cards to insure that all cards accepted are being recorded and sample the daily cash register tapes.

4. In reconciling the bank deposits be aware that credit card tips will normally reduce the cash deposited into the bank account. This is because the servers will take the credit card tips out of the cash drawer when they balance out at the end of each day. Ask the owner what records are kept of the cash taken out of the till by the servers to reimburse for credit card tips. Sample these records.

Cash Sales

Restaurants are cash intensive businesses that include many small transactions paid for with cash. As such, determining that all income is reported requires tying down the cash account. Cash that is deposited daily needs to be reconciled with the cash register tapes and the deposit slips. Cash sales that are deposited into a bank account are reduced by cash pay outs and credit card tip reimbursements to employees. As a minimum income probe, a bank deposit analysis needs to be done to reconcile the cash received from sales and the cash deposited.

Because each server and bartender has access to the cash received by the business there is a greater chance of theft of cash by employees than in other businesses. It is important to determine the internal controls that the owner has to protect against employee theft and embezzlement. Undeposited cash receipts may indicate that the owner has not been reporting income, or that employees are taking cash out of the business. Consider extending the audit to employees who are suspected of embezzlement or theft, or as a minimum make an audit referral by completing an information item referral form.

Audit Techniques for Verifying Cash and Unreported Income

1. Scan the journal entries for reductions to cash that are unusual.
2. Request a copy of any cash flow statements prepared for the business.
3. Perform a bank deposit analysis as a minimum income probe.
4. Sample cash pay out slips
5. Review bank reconciliation
6. Be aware of internal control issues regarding cash sales not rung on machines that were discovered during the interview.
7. If necessary, interview individual employees. Follow third party contact requirements before doing so.

INVENTORY ─ IRM 4.10.3.8.4.3

Inventories can be a large and material income producing item in the bar and restaurant area. A comment must be made in your work papers about its stated value on the tax return. Inventories on a bar and restaurant return would largely consist of food and alcohol items sold in the establishment. Since food items are perishable goods, be aware that food items are subject to waste and spoilage and most items have a rapid turnover rate. Poor controls and safeguards of inventory items may result in employee theft. If significant and identified, income from employee theft should be included as income on the employee's return.

Employee meals may be a non-taxable fringe benefit to the employee, while reducing inventory and cost of goods sold for the employer. Determine if this is a taxable or non-taxable arrangement. Determine the owner's personal consumption of meals and/or removal of food or alcohol from the premises. These amounts may constitute income to the owner. IRS Announcement 98-77, 1998-2 C.B. 245, clarifies IRS sections 119, 132, and 274 regarding the taxability of employee meals in the hospitality industry.

Find out if the bar or restaurant has a system of reducing inventory at the point of sales. Find out if a meal pricing system is used. Both of these measures result in fewer write-offs of waste and spoilage. Determine if the bar or restaurant has adequate pricing systems in place to determine gross receipts based on purchases and cost of goods sold. For example, if a meal pricing system shows that 1/4lb of hamburger goes into every hamburger sandwich sold, and 200 lbs. of hamburger is sold, then this would indicate 1,000 sales of hamburger sandwiches.

Determine the taxpayer's method of accounting for inventory (cash or accrual). Be aware of Revenue Ruling 2000-22, 2001-1 C.B. 1008, which allows the cash method for certain businesses.

Audit Techniques For Verifying Inventory

1. IRM 4.10.3.8.4.3 for Inventories (Make the following minimum checks): Verify that the method of inventory valuation conforms to the "prescribed methods" as indicated in Treas. Reg. section 1.471 and Revenue Ruling 2000-22, 2000-1 C.B. 1008.

2. Compare inventory balances in the return with those for the prior and subsequent years and with taxpayer's records. This could result in understatement or overstatement of cost of goods sold.

3. Check for unauthorized changes from cost to cost-or-market or from accrual to cash. Make certain the taxpayer has complied with Rev. Proc. 2000-22, 2000-1 C.B. 1008, and 2001-10, 2001-2 I.R.B. 272.

4. Check for gross profit percentage variations. This could indicate withdrawal of inventory for personal use, which is an understatement of net income. Personal use of inventory is a constructive dividend to the shareholder.

5. Determine meaning and significance of any notes or qualifying statements on financial reports prepared by independent accounting firms.

6. Determine that all direct and indirect overhead and burden expenses are in the overhead pool that is used in the computation of overhead rates where applicable.

7. Analyze unusual entries to cost of sales account for labor, material, and burden charges not related to sales.

8. Determine that year-end purchases were included in closing inventory.

9. Check to see if contributions of food are being double deducted, once in cost of goods sold and again as a charitable contribution.

10. Determine if there have been write-downs for "excess" inventory to below cost. Verify that the method of inventory valuation for "excess" inventory is in accordance with Revenue Ruling 80-60, 1980-1 C.B. 97.

11. Determine the amount of food and alcohol consumed by employees and/or owners. Determine the amount of spoilage and waste. Determine amount of employee theft of food and alcohol.

12. If food or liquor purchase information is not available, consider third-party contacts of vendors and suppliers. Also, the state liquor control board may be a good source of information on purchases and sales. If necessary, employees may be interviewed. Follow third-party contact procedures. (See IRM 7.4.1.2.1.1.)

LOANS TO SHAREHOLDERS ─ IRM 4.10.3.7.6

Many bar and restaurant corporate returns will be closely held corporations. Many of these will have loans to the shareholders. The following information will provide the general audit techniques to use when addressing this issue.

Audit Techniques for Loans To Shareholders

Obtain copies of any notes or evidence of indebtedness. Test them to see if the terms of the note are being followed. For example, is interest (if any) being accrued as income. Does the loan call for monthly payments or is it payable on demand? Does the note have a fixed maturity date? Does it have an interest rate? Is the interest rate near market? The absence of one or all of the above may indicate the loan was made at less than an arm's length transaction, and may be construed to be a constructive dividend (or, alternatively, interest income).

Items indicative of a true loan include:

1. Signed note.
2. Security or collateral given.
3. Definite repayment date.
4. Period repayments of prior withdrawals.

5. Interest charged and paid.
6. Shareholder has available funds to repay outstanding balance.

Items indicative of a dividend:
1. No note or open account
2. No security given
3. No specified repayment date.
4. No repayment to date.
5. No interest charged.
6. Shareholder cannot repay his or her outstanding balance unless his or her interest in the corporation is liquidated.

Standard Audit Index Number (“SAIN”) Discretionary Audit Procedures For Loans to Shareholders

1. Analyze the composition of the account balance.
2. Trace the source of repayments.
3. Determine whether or not a bona fide debtor-creditor relationship exists.
4. Ascertain whether the current year's increase represents dividends.
5. Determine that interest income has been properly recorded.
6. Follow SAIN Program 218 (Loans from Shareholders/ Liability) where applicable.

FIXED ASSETS ─ IRM 4.10.3.7.7

The initial investment to start a bar and/or restaurant is quite high. Capital is required to purchase property, make leasehold improvements, buy equipment and furnishings, pay possible franchise fees, and purchase licenses, permits, taxes, liquor licenses, utilities, insurance, food inventory, advertising and payroll.

Be aware that the taxpayer may choose to reduce the capital requirement and lease the property for the establishment. Make sure during the examination that the lease is an arm's length transaction and that leasehold improvements are being correctly treated.

Of the capital items discussed above, fixed assets will make up a large percentage of the investment. The basic fixed assets that will be found in any bar and/or restaurant are as follows:

<u>Kitchen Equipment</u>	Stove, grill, fryer, walk-in freezers, walk-in refrigerators, ovens, dishwashers, and storage equipment.
<u>Office Equipment</u>	Desk, computer and telephone
<u>Property</u>	Fencing, building, and outside seating

Dining Room	Tables, chairs, music (stereo/speakers), jukebox, cash register, floor coverings, salad bar, coffee makers, soda fountains, silverware, glassware and dishes.
Bar	Refrigerators, cash register, sinks, bar, glassware, ice machine, ice bin, draft beer dispensers, alcohol dispensers, telephone, and coin-operated machines.

These fixed assets vary in cost and you may want to do some research to determine if the assets are being carried at a reasonable cost.

SAIN Discretionary audit techniques for fixed assets:

1. Review the acquisitions to determine that basis has been properly recorded.
2. Where the acquisition consideration is other than cash, fully review the manner at arriving at basis.
3. Does the basis include all expenditures required to place the asset in readiness for operating use?
4. Allocations should be reviewed where a lump sum purchase price is involved.
5. If there is an allocation in the contract between buyer and seller, verify that the allocation is consistent with the agreement. Also verify that the allocation reflects economic reality.
6. If there was an acquisition of assets constituting a trade or business, IRC section 1060 may apply.
7. Consider the advisability of requesting Engineering assistance.
8. Review retirement policy and determine that receipts from dispositions are properly accounted for.
9. Determine company policy with respect to capitalization of minor items and record the information for future references in the Historical File.

INTANGIBLE ASSETS ─ IRM 4.10.3.7.8

Treatment of Organizational and/or Start-up Costs over 60 months. In ***Walsh v. Commissioner***, T.C. Memo. 1988-242, ***aff'd***, 884 F.2d 1393 (6th Cir. 1989), a taxpayer was denied expenses incurred in opening a restaurant because the expenses were start-up costs. The taxpayer could not amortize the expenses until the following year when the restaurant opened to the public. The Service has sometimes allowed expenses associated with opening a new restaurant to include the salaries and travel expenses of the manager and opening team, salaries of newly hired employees during their pre-opening training, and costs associated with advertising. These were deductible as ordinary and necessary current operating expenses of the Parent Corporation who was expanding its line of restaurants. The rationale of ***Briarcliff Candy Corporation v. Commissioner***, 475 F.2d 775 (2nd Cir. 1973), stated that start-up costs need not be amortized when those costs have been incurred for expansion of an existing business and didn't create a new or distinct capital asset. However, when a new subsidiary corporation was formed to comply with liquor license requirements of local ownership, pre-opening expenses could not be deducted and are treated as a capital asset and amortized.

Valuation of assets, licenses, and goodwill amortized over 15 years. See IRC section 197.

Covenants-not-to-compete are treated as IRC section 197 intangibles only if acquired in connection with the business before 1993. Otherwise, amortize under IRC section 167 over 15 years.

This page left intentionally blank.

CHAPTER 7
EMPLOYMENT TAX ISSUES

PACKAGE AUDIT ─ INTERNAL REVENUE MANUAL

Refer to IRM 4.10, *Examination of Returns Handbook*, Chapter 5 for information on required filing checks. Pay close attention to the following exhibits:

- 4.10.5-1 Minimum Requirements,
- 4.10.5-2 Pro-Forma Required Filing Checks,
- 4.10.5-3 Pro-Forma Employment Tax Checksheet.

Note: Remember when opening an employment tax examination, other return statutes need to be protected. A Form SS-10 would be required for employment tax in addition to the appropriate Form 872 or Form 872A for income tax.

Part of the examination of a corporate return consists of the package audit requirements. Since agents should already be aware of these procedures, this section shall pertain specifically to the examination of restaurants and bars, with an emphasis on the various forms needed for audit or inspection.

Required Forms:

1.	Forms 1120 or 1040	Any delinquent 1120 or 1040 returns required to be filed.
2.	Forms 8027	Form 8027 Employer's Annual Information Return of Tip Income and Allocated Tips. If tip adjustments are required for employees, obtain needed employees' returns.
3.	Forms W-4	Inspect for number of exemptions.
4.	Forms W-2	Scrutinize all Forms W-2 for any withholding which appears to be small in relationship to the wages and request the employees Forms W-4. In the event an employment tax examination is warranted, the information needed is whether the FUTA and FICA limitations have been met. Determine if any wages have been paid in cash and make sure that Forms W-2 have been issued.

		Determine if there are any "off-the-books" employees being paid in cash and not being issued Forms W-2.
		Determine if back-up withholding was properly applied to illegal aliens. Consult your employment tax coordinator specific issues in your area.
5.	Forms 1099	Consider the issue of independent contractors vs employees. Determine if cash has been paid to bands and/or other entertainers and if Forms 1099 were filed.
6.	Forms 940 & 941	Employment tax returns
7.	Forms 1040	Constructive dividends and excess standard of living.
8.	Forms 8300	Currency Transactions over $10,000 (in conjunction with the audit of the cash account).
9.	Bartering	Consider along with the audit of the income account.
10.	Forms 5500 & 5500C	Review pension expenses and distributions.

EMPLOYMENT TAX COMPLIANCE

The restaurant and bar business is largely a cash business. As a result, many owners pay people for services rendered in cash. Two areas to consider when auditing these entities are cash paid to employees and cash paid to bands and/or other entertainers. The cash paid to the employees generally will not have employment taxes paid on it. The cash paid to the bands and/or other entertainers generally will not have a Form 1099 filed for it. Be sure that these areas are addressed in every examination of restaurants and bars. See Exhibit 7-1 for list of questions to ask at the interviews.

Another area involves the requirement that the tipped employees in the establishment report their tips received to the employer at least monthly. The Omnibus Budget Reconciliation Act of 1987 revised IRC section 3121(q) to require the Employer to match the FICA Taxes of the employee for tips reported.

The Service has implemented a "National Tip Rate Determination/Education Program". The program is discussed later in this chapter.

Tip Income ─ Form 8027

Form 8027 is the Employer's Annual Information Return of Tip Income and Allocated Tips. See IRC section 6053 (c). To increase tip income reporting compliance, the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") enacted substantial changes to requirements for reporting tip income earned by employees at large food and beverage establishments. For calendar year 1983 and later, employers at large food and beverage establishments are required to file Form 8027, *Employer's Annual Information Return of Tip Income and Allocated Tips,* indicating the amount of gross receipts from food and beverage operations, total charge tips, total credit card receipts, and total credit card tips. See Exhibit 7-2 for a list of Internal Revenue Service (IRC) sections that apply to tip income.

Treas. Reg. section 31.6053-3(j)(7) defines a "large food and beverage establishment" as one to which **all** of the following apply:

- Food or beverages are provided for consumption on the premises,
- Tipping is a customary practice, and
- On a typical business day during the preceding calendar year, more than 10 employees were normally employed.

The regulations state that an establishment has more than 10 employees on a typical business day, if the average number of employee hours worked per business day in the previous year was greater than 80 hours. See Treas. Reg. section 31.6053-3(j)(9). This test should not be applied, however, to treat an establishment with 10 or fewer employees as a large food and beverage establishment.

Form 8027 is an important tool used to measure the compliance level of large food and beverage establishments. Therefore, it is critical that IRS examiners identify taxpayers that have not filed Forms 8027 but are required to do so. Also, a significant amount of allocated tips reported on Form 8027 might be an indicator of employees' underreporting their tip income. Refer to the tip training guide mentioned at the end of this discussion for more information for reviewing Forms 8027. See Exhibit 7-3 for an audit program for tip income.

Tip Rate Determination and Education Program (TRDA and TRAC)

In the past, the IRS performed examinations on the returns of tipped employees and determined that a large number of these employees were not properly reporting their tips. Significant tax deficiencies often result from these examinations. These examinations created significant burdens not just for the employees and the employer, but also for the IRS. The IRS began to explore new methods to achieve voluntary compliance and at the same time reduce the burden for all parties concerned. These efforts resulted in the IRS tip compliance program, The Tip Rate Determination and Education Program ("TRD/EP") was introduced in October 1993.

The TRD/EP introduced a nontraditional approach in an important area of noncompliance. The program is intended to increase employees' reporting of tips to their employers by means of customer outreach and education rather than by traditional enforcement methods. The program involves execution of an agreement, either a TRDA or TRAC, between the business owner and the IRS. Both the employer and IRS agree to certain terms under these agreements. A TRDA is available for the food and beverage industry, and there is one specifically for the Gaming (casino) industry. TRAC is available to employers in the food and beverage industry, and there is one specifically for the Cosmetology and Barbering Industry. Recently, new TRAC and TRDA agreements were released for public comments. Other industries where tipping is customary now may participate in this highly successful program. Copies of TRDAs and TRACs can be accessed from the IRS web site at **www.irs.gov**.

Participation in either a TRDA or TRAC is entirely voluntary. Section 3414 of the IRS Restructuring and Reform Act of 1998 prohibits IRS from threatening to audit any taxpayer to coerce the taxpayer into entering into a TRAC agreement. No representative of the Service should threaten an audit when meeting with a taxpayer to solicit participation in either agreement. However, you should consider a tip examination if a taxpayer does not sign up for either of the two agreements, does not take any action to increase compliance, and there is sufficient evidence of significant underreporting of tip income. IRS policy requires an interval of at least 6 months from the date of the initial contact and the beginning of a Tip examination. If there are subsequent contacts, then the IRS should wait 6 months from the last contact to solicit an agreement before beginning a Tip examination.

The IRS identifies restaurants that may have unreported tips by analyzing the annual Form 8027 required of each establishment meeting the filing requirements. The analysis identifies discrepancies between the charged tip rate and the reported tip rate. This information is then used to prioritize the establishments by greatest discrepancy. Determining the correct amount of tip income earned by tipped employees is difficult. In the absence of accurate records, an indirect method for determining the correct tip income, referred to as the McQuatter's Formula, has often been applied for these situations, as discussed later.

Refer to Chapter 7 of IRM 104.6, *Employment Tax Handbook*, for more information on the TRD/EP and on tip examination procedures, as well as on Form 8027. Examiners need to contact their local Employment Tax group for the most current policy and procedures related to tip examinations. A tip training guide is also available that provides more details on this program and audit procedures for performing tip examinations. At the time of finalizing this guide, the tip training guide was in the process of being revised. The training guide is currently being rewritten and will be available soon.

Notice 2001-2, 2001-2 I.R.B. 261, discusses the Employer Tip Reporting Alternative Commitment program ("EmTRAC"). This program allows for food and beverage employers to prepare their own tip reporting program and receive IRS approval as long as they agree to:

1. Comply with the requirements for filing all required federal tax returns and paying and depositing all federal taxes

2. Maintain the following records for at least 4 years after the April 15 following the calendar year to which the records relate:

   a. gross receipts subject to tipping, and
   b. charge receipts showing charged tips

3. Upon the taxpayer's request, make the following quarterly totals available, by establishment, for statistical samplings:

   a. gross receipts subject to tipping,
   b. charge receipts showing charged tips
   c. total charged tips, and
   d. total tips reported

4. Operate its EmTRAC program as indicated in the program documents in the announcements.

5. Comply with the terms of the IRS approval described in Notice 2001-2.

IRS approval includes the following commitments on the part of the IRS:

- The Service agrees not to initiate any new tip examinations of the taxpayer for any of the establishments included in the taxpayer's letter for any period during which the taxpayer's EmTRAC program is in effect.

- Any IRC section 3121(q) notice and demand relating to any period during which the EmTRAC program is in effect will be based solely on amounts reflected on Form 4137, Social Security and Medicare Tax on Unreported Tip Income, filed by an employee with his or her Form 1040, or Form 885-T, *Adjustment of Social Security Tax on Tip Income Not Reported to Employer,* prepared at the conclusion of an employee tip examination.

- The Service will not evaluate the EmTRAC program until the second quarter following the date of the letter. The Service can review the progress in implementing the EmTRAC program before then.

- The EmTRAC program will remain in effect until the taxpayer or the IRS terminates it. The Service can terminate the program only:

1. If the taxpayer fails to comply with the agreement described in the letter

2. If the Service pursues an administrative or judicial action relating to the taxpayer, an establishment, or any other related party to the taxpayer's EmTRAC program.

3. Following a significant statutory change in the FICA taxation of tips, or

4. After May 31, 2005

- Any termination will be effective the first day of the first calendar quarter after the terminating party notifies the other party in writing, unless the taxpayer fails to comply with the agreement. In that case, the Service may terminate the EmTRAC program effective as of the first day of the quarter in which the taxpayer ceased to comply.

Requests for approval must be sent by taxpayers to:

Internal Revenue Service
OP: EX: ST: ET Room 2404
Attn: EmTRAC Coordinator
1111 Constitution Avenue N.W.
Washington, D.C. 20224

Discussion of McQuatters Formula

Since tips are often paid in cash, there may no record of them. Therefore is may be difficult to determine the correct amount of tip income earned by bar or restaurant. If the tipped employees fail to maintain accurate records of their tip income, the IRS must rely on an indirect method of determining that income. However, indirect methods are time consuming and may yield inconsistent results.

Realizing the inadequacies of other methods, examiners focused on the restaurant's records rather than those of individual tipped employees. In ***McQuatters v. Commissioner***, T.C. Memo 1973-240, the Tax Court specifically addressed the factors to be considered in determining a tip rate on the basis of the restaurant's records. It also addressed adjustments in the tip rate determined in this way. These factors were incorporated into a computation known as the "McQuatters Formula." (**Note:** In order to use the McQuatters Formula, the establishment in question must have a ratio of charges to gross sales that is over 5 percent. If the ratio is 5 percent or less, it is considered to be a "cash business," and the McQuatters Formula is not used. If an establishment has a ratio of 5 percent or less, consult your local Employment Tax group.)

If properly applied, the McQuatters Formula yields a defensible estimate of tip income. Courts have consistently upheld the IRS in cases where a valid statistical sample was used to determine tip income.

The McQuatters Formula, with some modifications, also furnishes an effective method to calculate aggregate unreported tips. Rather than analyzing all daily charge receipts, the IRS uses a 28-day sample to determine an establishment's total charged tips and charged sales. This same sample may also be used to calculate gross sales subject to tipping and the number of hours worked.

The McQuatters Formula is used:

- to determine tip rates for TRDA/TRAC agreements,
- to validate tip rates reported on Forms 8027, and
- in examinations.

Refer to IRM Handbook 104.6.7.13. for more information on the McQuatters Formula.

Employer-only FICA Tax Assessments

The IRS announced in October of 1999, that beginning October of 2000, the IRS would conduct employer-only FICA Tax assessments on employers for the employer's share of unreported tip income. This policy change came about as a result several court cases that allowed the IRS to conduct employer-only FICA assessments.

The U.S. Supreme Court June 17, 2002, held 6-3 that the tax law authorizes IRS's use of the aggregate estimation method to calculate a restaurant's employment tax liability for unreported tip income. ***United States v. Fior D'Italia, Inc.***, U.S., No. 01-463, Jun. 17, 2002. The issue was whether the IRS could make employer-only assessments of FICA tax on unreported tips on an aggregate basis under IRC section 3121(q). If you are conducting an employer-only FICA Tax assessment examination, please coordinate with your local area employment tax group and the National Office.

This page left intentionally blank.

Interview Questions

Note: All questions pertain to the year(s) under examination.

MANAGEMENT INTERVIEW:

1. Days open?
2. Hours open?
3. Number of shifts?
4. Average number of employees on each shift?
5. Did employees work the same shift on a regular basis?
6. If not, how were shifts rotated? How were different shifts recorded?
7. Who set up the room?
8. What was the average set-up time?
9. How was set-up rotated?
10. If stations were not rotated, how were they assigned?
11. What was the seating capacity of the restaurant?
12. Were tips pooled and split among waitpersons?
13. How were tips split?
14. If tips were not split, was there a practice of tipping out? To whom and at what rate?
15. How did customers pay for their meals? (That is, did they pay the waitperson or pay on the way out?)
16. How did the employees receive their charged tips?
17. Did you have the following types of sales?

Charge sales	Est. % of sales
Banquets	Est. % of sales
Complimentary sales	Est. % of sales
Ticket/Tour sales	Est. % of sales

18. If you had the types of sales listed above, how did the employees receive any non-cash tips?
19. Were waitpersons required to pay for customers who left without paying?
20. Did the average cash customer tip better or worse than the average charge customer?
21. Did customers tip differently depending upon the time of day?
22. Were there any unusual factors that affected tipping in your establishment?
23. Other Comments:

EMPLOYEE INTERVIEW

Name of Employee Interviewed:

1. Who was your manager?
2. How many shifts were there?
3. How many hours did you work in each shift?
4. Did all waitpersons work set-up and breakdown?
5. If not, who did and how long did it take?
6. Did you have a steady schedule?
7. Were shifts rotated?
8. How were they rotated?
9. How were stations assigned?
10. Were stations rotated?
11. How were they rotated?
12. What was the average number of tables per station?
13. What was the average number of chairs per station?
14. How many tables on the average did you serve per shift?
15. How many checks on the average did you write per shift?
16. Who assigns the workstations?
17. Who assigns work shifts?
18. Did the average cash customer tip better or worse than the average charge customer? By how much?
19. Were tips pooled?
20. If so, how were they split?
21. If tips were not pooled, with whom did you share your tips and at what rate?

	Dollars	Percent	How Often
Buspersons			
Cocktail Waitperson			
Bartender			
Captain			
Host/Hostess			
Maitre d’			
Owner/Manager			
Other			

22. From whom did you receive a share of tips?

	Dollars	Percent	How Often
Buspersons			
Cocktail Waitperson			
Bartender			
Captain			
Host/Hostess			
Maitre d'			
Owner/Manager			
Other			

23. On an average night, average week, or average month, how often would you get stiffed?
24. If a slow night occurred, was anyone sent home and how was that decided?
25. If sent home, did you get paid for the hours worked or for a full shift?
26. Did you have to pay for walkouts?
27. If yes, how often did this happen?
28. What is your position?
29. What are your duties?
30. How long have you worked at this establishment?
31. Have you worked in any other position at this establishment? If so, what were your duties?
32. Did you maintain records of tips you received?
33. If yes, what kind of records?
34. Was there a guaranteed tip rate at any time?
35. Did anyone work all large parties?
36. If yes, how was this determined?
37. Are customers who receive complementary food or beverages better or worse tippers than the average customer?
38. Were checks written up so that you could be identified?
39. If so, how was this done?
40. Is there a reason why application of average sales and tips would be unfair to you?
41. Other Comments:

This page left intentionally blank.

Internal Revenue Code Sections that Apply to Tip Income

IRC Section	Synopsis of IRC Section
45B	Allows an income tax credit to food and beverage employers for part of the employer FICA taxes paid on tips.
61(a)	Provides that tips are compensation for services.
446(b)	Gives IRS the authority to compute income by a method that, in its opinion, clearly reflects income.
3102(c)(1)	Provides that the employer is to withhold FICA taxes only on tip income reported to the employer by the employee in a written statement.
3121(q)	Provides that, effective January 1, 1988, all tips are FICA wages, and the employer is responsible for the employer share of FICA on tips earned, whether or not reported by the employee.
3306(s)	Imposes FUTA tax on tip income reported to the employer by the employee.
3401(a)	Defines “wages” for purposes of federal income tax withholding.
3402(k)	Provides that an employer is to withhold federal income tax on tip income reported by the employee in a written statement.
6001	Requires taxpayers to keep records sufficient to enable them to determine their correct tax liability. Specifically requires employers to keep copies of charge receipts, copies of tip reports, and records necessary to comply with tip reporting requirements of IRC section 6053(c).
6051	Requires employers to provide a written statement to employees (Form W-2).
6053	Authority for tip reporting requirements for employers and employees. Establishes rules for tip allocation and filing Form 8027.
6652(b)	Authority for assessing a 50 percent penalty against employees for FICA taxes due on unreported tips.
6662	Authority for assessing a 20 percent penalty on the underpayment of tax for negligence or substantial understatement in reporting income, including tips.
6721	Imposes a $50 penalty for failure to file Form 8027. Also, if an employer failed to furnish a written statement to the employee showing additional FICA due, failed to allocate tips, or made an incorrect allocation, there is an additional $50 penalty per Form W-2, with a maximum of $250,000.
6722	Imposes a penalty of $50 for each failure to furnish a written statement to the employee showing additional FICA due, failure to allocate tips, or making an incorrect allocation. There is a maximum of $100,000 in penalties to the employer during any calendar year.

This page left intentionally blank.

Exhibit 7-3

Audit Program for Tip Income

1. Interview Management and Employees	Interview knowledgeable individuals to determine the tipping practices and factors causing differences between charge and cash tip rates.
2. Order Returns	In event of tip adjustments, order all returns for directly and indirectly tipped employees using the information from Forms W-2.
3. Verify Sales Information	Identify those sales subject to tipping. Separate, when necessary, sales subject to tipping at different rates or earned by different categories of directly tipped employees.
4. Determine Charge Tip Rate	Use the Form 8027 if establishment filed an accurate return. Use a 28-day sample if establishment does not have adequately organized records.

.

This page left intentionally blank.

APPENDICES

Appendix 1

GLOSSARY OF TERMS AND MEASUREMENTS

Allocated Tips **—** Tips that the employer assigns to the employee in addition to the tips reported by the employee to the employer when tips reported are less than 8 percent of food and drink sales. The employer reports the allocated tips to the IRS on the Form W-2. The employee completes Form 4137 which is attached the employee's tax return. Employer does not pay FICA tax on allocated tips.

Autogratuity **—** An autogratuity is a service charge that is automatically posted to a guest check. An autogratuity affects all items that are linked to it. Percentage autogratuities are different from regular percentage service charges. A 15-percent autogratuity is updated by a point-of-sales system even when checks are split. A regular autogratuity is applied once at the end of the transaction.

Automated Bar Control Systems **—** Computer based systems to control the bar and alcohol operations. This includes a metered system and a keg beer control system. These systems record the number of drinks, portion sizes, drink pricing, and collect other data on sales such as brand, serving station, hour, and drink type.

Basic Cash Register Machine **—** Has a paper tape of all recorded transactions, an internal meter that records cumulative data totals, and a cash drawer that secures cash receipts. Allows for recording of various food and beverage items, has a sales tax key, and change due. Tips are not recorded.

Call Drink **—** A drink made with a name brand liquor.

Cashier Banking **—** Server takes order from the customer, and the cashier rings up the sale, the server takes payment from the customer and gives to the cashier who rings up the payment and makes change and gives the information back to the server to give to the customer. At the end of the shift, the cashier balances out the till and gives the server a copy of the server's sales and tip report.

Charged Tip **—** Charged tips are tips added to a credit card slip or a room charge slip. Charge tips are credited to the check employee.

Check employee **—** Employee who deals directly with the customers such as the waiter or server to takes the order and brings the food to the customer. The same employee also gives the customer the check or sales slip, and receives payment from the customer.

Check digit verification **—** validates the accuracy of credit card account numbers that are entered during transaction processing.

Complementary (Comp) Sales ─ This is when a meal or drink is served, but the customer is not required to pay, for example, management courtesy meals. Generally, a tip is left as in the case of a regular paying customer.

Cover Charge ─ Charge for admission into restaurant and bar, usually because of live entertainment.

Diner Discount Funding Programs (DDF) ─ A funding source provides the restaurant with a cash advance that can be used however the owner chooses. In exchange, the funding source receives food and beverage credits generally equal to twice the cash advance amount. The funding source then provides credits to members who redeem them by signing special credit card receipts for their bills at full price. The restaurant receives a check from the funding source for the tax and tip amounts. The remainder of the bill is applied to the restaurant's advance balance. Revenues are deferred and may not be ever recorded as current income.

Directly Tipped Employee ─ This is an employee who receive tips from the customer directly.

Employee Banking ─ The employee carries a purse or pouch, takes orders from customers, takes payment from customer, makes change for customer from "bank," and keeps record of the sale which is balanced out against the cash register at the end of the shift.

Employee Tip Report ─ In a point-of-sales system, employee tip reports are printed out at the end of each day. This same report can be cumulated and printed out for each payroll, quarter, or annually in a point-of-sales system. The following totals are included in each report:

1. Gross Receipts (total sales credited under the employee's name
2. Credit Card Sales (total charged sales)
3. Credit Card Tips (total tips received from credit card sales by employee)
4. Cash Sales (total cash sales under each employee's name)
5. Service Charge receipts (total service charges payable to the employee)
6. Cash Tips Reported (total cash tips reported by employee)

Employee meal ─ meal eaten on the premises by the employee. Usually considered a nontaxable fringe benefit as a meal provided for the convenience of the employer. Most point-of-sale systems have a separate key for recording employee meals.

Employer FICA Tax Credit ─ Credit against income tax for amount of employer FICA tax paid on employees tips.

Employment Tax Audit ─ Audit of the Forms 941 and 940 for both the employer's share of FICA and the employee's share of FICA and withholding tax.

Expanded Cash Register Machines ─ Records sales, server information, guest check information, discounted meals, promotional or complementary meals, employee meals, and identifiable menu items.

Fast Food Restaurant — Does not employ servers who take orders. Customers will place and pick up their own orders and often bus their own tables.

Food Cost — The cost of all food items purchased for resale; does not include the cost of supplies

Food Cost Percentage — The portion of cost divided by the menu price.

Franchise Fee — Cost paid to franchise owner for operating a franchise. Other franchise costs include royalties, advertising, rent, etc.

Full Service Restaurant — Servers are employed to take orders and may include alcohol services.

Guest Check Information System — Produced by the integrated point of sale system, a guest check is created showing the written description of the order, server's name, number of customers, table number, and how paid, and tip.

Guest Seat — Usually each chair in the restaurant is kept track in a point of sales system. Also, each server is assigned a chair or seat. The information used can show how many sales are recorded by each chair or seat.

Indirectly Tipped Employee — An employee who receives tips from directly tipped employees through either tip pooling or tip splitting. In a point-of-sales system, employees record their cash tips in the system using an *indirect tips* or *direct tips* key.

Integrated Point of Sales Systems — Cashiering functions of the expanded cash register machines plus order entry or automation of the ordering process. It captures the order from the time that it is taken, to transmission to the kitchen area, to the time of payment. Time recording is also possible with a link to an actual time clock. Can be linked to a back office computer to convert data into a management analysis system of the data collected.

Keg Beer Control System — A push button panel that dispenses the exact portion of beer replaces the conventional beer tap.

License Fee — Cost of maintaining right to serve alcohol, usually to a government agency. After RRA '93, this intangible asset can be amortized over 15 years for licenses acquired after August 10, 1993. Per GAAP, APB Opinion No. 17 requires disclosure of write-off and use of straight-line method.

Liquor Cost — The amount paid for liquor after discounts; does not include bar supplies, mixers, etc.

Liquor Cost Percent — The portion cost divided by the selling price.

Menu Price — The amount that will be charged to a customer for the item.

Menu Pricing ─ A technique of calculating the actual cost of goods sold by cost to purchase each ingredient within each item of the menu. For example, determining the cost of a hamburger bun, slice of cheese, and meat. Based on the cost, a profitable selling price for each menu item can be determined.

Metered Systems ─ A system using a metering device to record each drink served. They attempt to hold the bartender accountable for every drink poured. Some systems use a "gun" dispenser that travels through a system of hoses from the storeroom where the liquor is kept to the gun. Other systems use a spout attached to each bottle that dispenses a predetermined portion. The bartender must attach a collar around the spout to activate. The collar records the drink and releases the alcohol.

Net Purchase Price ─ The price paid by the restaurant for one unit (that is, pound, package, container, etc.)

Point of Sales System ─ Records the sale at the time the sale occurs. This can include basis cash registers, expanded cash registers, and integrated point of sales systems.

Portion Cost ─ The unit cost times the portion served.

Portion Served ─ The amount of an item served to a customer in an order.

Restaurant capacity ─ The amount of customers that can be served if all of the tables and chairs available for use, are used.

Restaurant Development Costs ─ Costs to find location, train employees, pre-opening advertising costs, fees paid for demographic studies. Under IRC section 195, these costs are required to be amortized over 60 months.

Service Charge ─ A service charge is any gratuity posted to a check, such as a room service or delivery charge. Direct and indirect tips are not service charges. A point-of-sales system will record a service charge.

Shrinkage ─ The amount lost as a result of cooking.

Spillage ─ The amount of alcohol lost during the drink making process.

Stiff ─ A stiff is when a customer leaves no tip.

Targeted Jobs Credit ─ Credit against tax for employing targeted groups.

Tip Audit ─ Audit of the employer's share of FICA tax on all the tip income of the employees and not just the tips reported to the employer. Special procedures require involvement with the Tip Coordinator for assessment.

Tips Paid — Tips paid out by the restaurant to the server for the credit card tips at the end of the shift when the server cashes out. These tips reduce the cash in the drawer from cash sales and reduce amount deposited to the bank in cash. These tips are recovered when the restaurant receives payment from the credit card companies.

Tips Declared — Amount of cash tips reported by the employee to the employer. This is not necessarily the amount of cash tips received.

Tip Percentage — The tip percentages is calculated taking as follows:
employee's total tips/employee gross sales receipts = tip percentage.

Trade-out — Trade-out arrangements are barter activities where the restaurant agrees to provide meals in exchange for some activity.

TRDA Agreements — The Service will work with the employer to arrive at a tip rate for the various occupations in the restaurant using the McQuartter's Formula. At least 75 percent of tipped employees must sign a participating agreement. Participating employees report tips at or above the rate determined in the agreement.

Tip-outs — These are tips shared from directly tipped employees to other directly and indirectly tipped employees, such as buspersons and cooks.

Tip Pool — In some instances the employees will put all of their tips together and then divide them equally or on a percentage basis. Sometimes they are divided based on hours worked.

Tipshare — This is when a directly tipped employee shares his/her tips with an indirectly tipped employee.

TRAC Agreement — The employer and the Internal Revenue Service agree to institute and maintain a quarterly educational program that trains newly hired employees and periodically updates existing employees as to their reporting obligations with respect to tips. The employer also agrees to establish a procedure to monitor the employees, the accurate reporting of all tips, and comply with all federal tax requirements regarding the filing of returns, paying and depositing taxes, and maintaining records.

Unit Cost — The purchase price divided by the applicable unit.

Walk-out — This is when a customer leaves the premises without paying the bill.

Weekly Profit and Loss Reports — Internal reports reconciling cash register tapes, deposits, purchases, and cash payouts. Reports provide detailed analysis of sales and costs.

Well Drink — A drink made with the less expensive non-name brand liquors.

Work Opportunity Tax Credit — Credit employers can receive for hiring people off of welfare.

This page left intentionally blank.

Appendix 3

COMMON METHODS AND INDICATIONS OF UNDER REPORTING INCOME

(Source: Ed Hynes and Walt Matysik, Restaurant Accounting Controls 2000 (Edmonds, Wa: Restaurant Seminar Institute, Inc., 2000), pgs. 109 to 113.)

1. Record a smaller sales amount on the daily operating report than is shown on the cash register tape. This reduces the amount of cash that must be deposited for the day.
2. Regular cash overages. This is an indication that sales are not being recorded, and a breakdown in controls.
3. Collect the side income (for example, vending machine proceeds, tee shirt revenue, gambling fees, and admission charges) and do not include the income on the daily operating report.
4. Collect directly from special customers, parties, and banquets and do not report the income on the daily operating reports
5. Purchase food and supplies for personal consumption without reimbursing the restaurant.
6. Deposit supplier rebates into the owner's person account without recording the payments in the books and records.
7. Purchase food for friends, charge them, and do not record any amounts collected and pocket the funds.
8. Turn off the register or leave the cash drawer open for periods of time (for example, during the lunch rush).
9. Turning off the register hours ahead of the close of the restaurant.
10. Refusing to purchase a register which records time of sales, and when machine is balanced out. Refusing to purchase a point-of-sales system claiming the cost is too high.
11. Balancing out the till days or weeks after the end of the shift.
12. Depositing cash from sales days or weeks after the end of the shift.
13. Never depositing any coins collected from daily sales.
14. Use two registers to record sales, and only report sales from one.
15. Creates a second set of records of sales on same machine at the end of every day with lesser totals than originally recorded. This is done on older models of cash register machines.
16. Key in a smaller amount on the cash register than is collected and pocket the difference.
17. Have a vending machine with no record of income received from vendor, usually in cash.
18. Kickbacks from suppliers.
19. Specific credit cards not rung as a payment, for example Diner's Club may never be rung up as a sale.
20. Reimbursement from employees for uniforms.
21. Omission of side income such as tee shirt sales or pool table fees.
22. Sales from certain tables or chairs are not recorded or even assigned to a server on the machines.
23. Higher than expected food and liquor costs but company still operates at a loss in excess of 3 years.
24. One person prepares all the records and there is no separation of duties.
25. Falsifying records or invoices.
26. Destroying books and records especially after contacted for examination.

27. The cash register machine is changed frequently or is lost but is not a computerized system.
28. Duplicate guest checks are not kept.
29. Owner has high lifestyle or is acquiring assets with no apparent source of income.
30. Owner conceals assets.
31. Making false statements to IRS agents regarding income.
32. Attempts to hinder the examination. For example, failure to answer pertinent questions, repeated cancellations of appointments, or refusal to provide records.
33. Testimony of employees concerning irregular business practices.
34. Transfer of assets for purposes of concealment, or diversion of funds to key officers or trustees.
35. Backdating of documents.
36. Attempts to bribe the examiner.
37. Using false Social Security Numbers.
38. Assets located under other names.
39. Transactions surrounded by secrecy.
40. Use of secret bank accounts.
41. Claiming fictitious deductions.
42. Intentional under or over footing of columns in journal or ledger.
43. Unable to locate cash registers tapes.
44. Unable to locate cash registers machines.
45. Depositing income in other family name bank accounts.
46. High employee theft and possible embezzlement.
47. No employees report any tips, and none are reported to the IRS by the employer.
48. Report of cash robbery with police department for cash located in the home.
49. Payment of most business expenses with cash or personal expenses with cash that has never been recorded as income.

Appendix 4

101 WAYS TO STEAL FROM A RESTAURANT

(Source**:** Ed Hynes and Walt Matysik, Restaurant Accounting Controls 2000 (Edmonds, Wa: Restaurant Seminar Institute, Inc., 2000), pgs. 109-113.)

METHODS PERPETRATED BY EMPLOYEES

1. Employee doesn't ring up sale and keeps cash.
2. Short ring; Under-ring the correct price of item and pocket the difference.
3. Service and collecting while register is reading between shift changes.
4. Claiming a phony walk-out and keeping money received from the customer.
5. Cooks requesting wine for the kitchen - and drinking the wine rather than using it for a menu item.
6. Picking up customer's cash and claiming it as a tip when the customer thought they were paying the bill.
7. Wrapping food, etc., and dropping into garbage can for later retrieval.
8. Fictitious coupon sales. Manager or employee accumulates coupons and exchanges them for cash.
9. Producing surplus food (such as sandwiches) so it can be taken home.
10. Mobile catering drivers purchasing and selling their own inventory for profit.
11. Overstating the tip and understating the customer's charge.
12. Server ringing up coffee and desserts and going to the kitchen to produce own order, bypassing the computerized system.
13. Cutting pie into a 7-piece rather than a 6-cut and pocketing the money for the extra piece of pie.
14. Server feeding friends for a free.
15. Taking home silverware or glassware and selling at garage sales.
16. Server destroying guest checks and keeping cash.
17. Server claiming child or senior prices, and charging full price.
18. Claiming that missing inventory items were spoiled and thrown out.
19. Keeping cover charge receipts, or underestimating the amount received.
20. Gift certificates stolen and used by employees.
21. Personal telephone calls.
22. Keeping funds from vending machines.
23. Employees taking food liquor on their way out the door for lunch or for the day.
24. Selling food "to-go" without entering into POS.
25. Employee overstating hours worked.
26. Changing pre-set prices on register and charging customer higher prices.
27. Claiming customer was unhappy with a meal and wasn't charged.
28. Collusion between cooks and servers-server does not record order on the pre-check system but the cook makes and issues the food without proper authorization.
29. Using old guest checks not in service.
30. Adding items to customer checks that were not ordered.
31. Confusing the customer with machine printed guest checks that are difficult to read.
32. Handwriting an additional item to pre-check guest checks.
33. Claiming that the opening bank was short.

34. Collects directly from the customer without a guest check.
35. Incorrect "Over rings."
36. Incorrect "Voids."
37. Making sales during ribbon or tape changes, or during shift changes.
38. Running a credit card through twice, or increasing the tip amount on a credit card.
39. Changing guest check after the customer leaves.
40. Employees under-charging a customer for drinks or food with the anticipation of a larger tip.
41. Short changing customers.
42. Employees’ sign-in early and check-out late, or other employees sign them in and out, and they don't work at all.

METHODS PERPETRATED PRIMARILY BY BAR EMPLOYEES

43. Complimentary cocktail or wine coupons from hotel room sold by maids to bar personnel, which they can place in register for cash.
44. Adding two different customers' drink charges together and charging both, claiming misunderstanding in who purchased the round.
45. Stealing change the customer left on the bar. Employees sometimes wet the bottom of their tray and set it on the customers change, so that the cash sticks to the bottom of the tray.
46. Collusion between bartender and cocktail server, where the server does not enter drinks into the system but the bartender makes and releases them.
47. Bartender totals out the register early. Then starts a new tape, totals it before he leaves and takes the tapes and cash with him.
48. Phantom Bottle: Bartender brings his own bottle or liquor onto shift and pockets cash from the sale.
49. Short Pour: Pouring less than shot to cover "give-away" liquor costs.
50. Duplicate pour on computerized dispense system. Dispensing and registering one shot, while short-shotting the liquor into two glasses.
51. Claiming a returned drink when the drink was actually sold.
52. Giving away free drinks: If no point-of-sale control exists and drinks are given to friends or in anticipation of larger tips.
53. Free drinks with cash on the bar: Customer places money on the bar, he is served without money being collected, customer leaves thinking he has paid for his drinks and left tip, but the bartender pockets the money without ringing up.
54. Confusing manager regarding the number of draft beers that are poured from a keg, but not ringing up draft drinks and keeping the cash.
55. Re-using old register drink receipts.
56. Cocktail servers understating sales when pre-check system is absent.
57. Bartender exchanges drinks with the cook for dinners.
58. Adding water to a liquor bottle to cover cost discrepancies. This covers not ringing up drinks.
59. Using lower priced liquor while charging for call brands.
60. When one person is in charge of liquor pick-up, check-in, and stocking, it is easy for them to take liquor home.
61. Charging regular bar prices, but ringing sale up as happy hour prices.
62. Bartender claiming new register or control is too confusing or time consuming and slows everyone down so they don't use it.

63. Ringing cash sales on service or dining room key.
64. Ringing food items on liquor key in order to cover high liquor cost percent.
65. Free drinks to all visiting bartenders "courtesy."
66. Not pouring liquor into blended fruit drinks to cover PC.
67. Bartender redlining service orderings without ringing, then ringing later for a lesser cash sale amount.
68. Tip jars next to cash register make it easy to place cash in tip jar and ring "no-sale" for register activity.
69. Falsifying cumulative register readings and "losing" tape.
70. Improperly using the training key (by ringing up orders on the training key).
71. Keeping free samples from venders.
72. Bartender handwriting bar tabs and ringing in lesser amounts into receipts.

METHODS PERPETRATED BY OUTSIDE PARTIES

73. Draft beer delivery person picks up one full keg as well as empties when leaving. This full keg is sold to another restaurant.
74. Draft beer system not secured at closing, available to janitor after hours.
75. Chefs demanding gifts of a personal nature in exchange for business from a purveyor.
76. Equipment supply companies sell unnecessary equipment or glasses that break and have to be replaced frequently.
77. Customers send bill for laundry due to alleged food spilled on them by server.
78. Individuals posing as representatives from credit card companies sell unnecessary supplied to unaware employees.
79. Kickbacks from food venders to employees (generally the chef or person doing the buying takes a commission and pays more for the merchandise).
80. Vendors deliver merchandise weighing less than the amount stipulated on the invoice (sometimes a collusion between the person receiving the merchandise and the delivery driver).
81. Linen service overcharge (taking wrong inventory and charging for invalid damaged merchandise).
82. People posing as representative of local newspaper selling phony advertising at lower rates.
83. Telephone company offers lower cheap long distance rate but never really changes the rate.
84. Restaurant is mailed phony bills from yellow pages or agencies selling phony labor law bulletins.

METHODS PERPETRATED BY MANAGERS, BOOKKEEPERS OR INDIVIDUALS WITH TOTAL SYSTEM ACCESS

85. Bookkeeper entering and printing check in QuickBooks for personal expenses, then going back into QuickBooks and changing vendor name to non-descript title and splitting the expense so that no amount seems out of line.
86. Manager buying software from a foreign country that enables him to reprint reports from open architectural system indicating lessor sales, and then pocketing the money.
87. Making phony daily reports.
88. The bookkeeper is not making deposits by reporting cash short.
89. Bookkeeper adds a "less cash" line to the deposit slip and receives cash back from the bank.

90. Bookkeeper claiming improperly written check, NSF check, or incorrect credit card transaction.
91. Bookkeeper writing a check to the bank for FICA and getting cash instead.
92. The bookkeeper is paying a fictitious bill to themselves.
93. Fictitious pay-outs added by bookkeeper. Sometimes employees do the same.
94. The manager adding hours to an employee's check and splitting the difference.
95. Over charging banquet sales, or not recording banquet sales at all.
96. Employee hold back deposits and investing or borrowing money. (Sometimes money is invested in drugs).
97. Manager sets up a phone employee on payroll and deposits checks into their account.
98. Chef purchasing specific items not on inventory for employee consumption.
99. Cashier accumulating guest checks to ring up after customer leaves. This enables cashier to change amount or leave out items.
100. Chefs asking purveyors to falsify invoices - transferring food purchases to supplies.
101. When manager is balancing cash from a computerized Point-of-Sale system, they change some cash sales to promotional meals and keep cash. They do this and other methods when cashing out employees.

Appendix 5

OPERATING RATIOS

1. Comparative Analysis: Compare current year income statement and balance sheet to previous or subsequent years. Preferably a 3-year spread.

2. Calculation of Percentages: First calculate the percent and then compare to industry average. The National Restaurant Association prints various statistics on their web site www.restaurant.org or www.nrs.com. Also check Nation's Restaurant News at www.nrn.com or Publicly traded restaurants at www.wsrn.com. Statistics of industry can also be obtained from National Restaurant Association Deloitte & Touche: Restaurant Industry Operations Report for 2000, which can be purchased from the NRA. Also, contact IRS Examination Specialist or ISP for Food and/or Restaurants for current statistics.

   a. Prime Cost % = Prime Cost (cost of food and beverage sold plus Labor cost)/Total Sales
   b. Food Cost % = Food Cost /Food Sales *
   c. Labor Cost % = Total Labor Cost/Total Sales
   d. Labor Cost % = Liquor Cost/Liquor Sales
   e. Wine Cost % = Wine Cost/Wine Sales
   f. Beer Cost % = Beer Cost/Beer Sales
   g. General and Administrative % = General Administrative Cost/Total Sales
   h. Sales per Seat = Total Sales/Number of Restaurant Seats
   i. Sales per Square Foot = Total Sales/Restaurant Square Footage
   j. Sales per Labor Hour = Sales/Full Time Employees
   k. Inventory Turnover = Cost of Goods Sold/Average Inventory

   *Food cost include coffee, tea, and juices sold with the meal. If no alcohol is sold, food costs include soft drinks.

3. Comparison of percentages to actual data compiled from National Restaurant Association Deloitte & Touche: Restaurant Industry Operations Report for 2000.

   a. Full Service Restaurants (average check per person under $15)
      - Median average check is $10.
      - Median total sales per full-time employee is $40,306 and average payroll is $13,893.
      - Median food sales are $5,490 ($2,788 to $8,724) per seat and medium beverage sales are $718 ($227 to $1,820) per seat.
      - Median sales for a profitable restaurant are $7,500 ($4,540 to $10,575) per seat and for an unprofitable restaurant is $5,057 ($2,600 to $7,433). Median net profit for a profitable restaurant is $480 ($211 to $1,065) per seat. Median net loss for an unprofitable restaurant is ($193) (($482) to (83)).
      - Median cost of sales per seat for food is $1,875 (1,009 to $2,924) and for beverage is $168 ($15 to $454).
      - Median net income before taxes is $318 ($31 to $872) per seat.

- Median total sales per square foot are $232.
- Median income before income taxes is 5.4 percent of total sales.
- Median total cost of sales is 31.6 percent of total sales.
- When 53 percent have sales volume of over $1,000,000

b. Full Service Restaurants (average check per person $15 to $24.99)
- Median average check is $17.
- Profitable restaurants report median total sales of $6,595 ($4,338 to $10,763) per seat while unprofitable restaurants report median total sales of $3,561 ($2,507 to $7,066) per seat. Average profits for a profitable restaurant per seat are $291 ($111 to $934). Average losses per seat for an unprofitable company are ($188) (($934) to ($117)).
- Median total sales per full-time equivalent employee are $40,953 and average payroll is $13,892.
- Median food sales are $4,258 ($2221 to $7413) per seat and median beverage sales are $1,108 ($629 to $2,070) per seat.
- Median total sales per square foot are $240 ($134 to $365).
- Median income before income taxes is 3 percent of total sales.
- Median total cost of sales is 34.5 percent of total sales.
- When 60.9 percent have sales volumes of over $1,000,000.

c. Full Service Restaurants (average check per person $25 and over).
- Median average check is $33.
- Profitable restaurants report median total sales of $11,115 ($7,129 to $16,302) per seat while unprofitable restaurants report median total sales of $6,526 ($5,175 to $8,490) per seat. Average net profit for a profitable restaurant is $696 ($306 to $1,253) per seat. Average net loss per seat for an unprofitable restaurant is ($227) (($650) to ($77)).
- Median total sales per full-time equivalent employee are $49,681 and average payroll is $16,159.
- Median food sales are $7,160 ($4,836 to $10,917) per seat and median beverage sales are $2,289 ($1,403 to $4,248) per seat.
- Median total sales per square foot are $332 ($209.61 to $464.50).
- Median income before income taxes is 3.9 percent of total sales.
- Median total cost of sales is 34.3 percent (31.4 percent to 37 percent) of total sales.
- When 76.3 percent have sales volumes of over $1,000,000.

d. Limited Service Restaurants
- Median average check is $5.
- Profitable restaurants report median total sales of $10,515 ($6,869 to $14,664) per seat while unprofitable restaurants report median total sales of $9,254 ($5,994 to $11,727) per seat. The average net profit for a profitable limited service restaurant is $758 ($344 to $1,645) per seat. The average net loss per seat for an unprofitable limited service restaurant is ($512) (($1,153) to ($159)).

- Median total sales per full-time equivalent employee are $45,726 and average payroll for food and beverage is $16,145.

- Median total sales per square foot are $270 ($194 to $370).
- Median income before income taxes is 5.8 percent of total sales.
- Median total cost of sales is 29.7 percent of total sales.
- When 79.7 percent have sales volumes of over $400,000.
- Take-Out/Drive Through is 55 percent of sales, Outside catering is 5 percent, and banquet services is 3 percent.

4. Statistical Analysis of the Bar Operation

a. Alcoholic Beverage sales as a per-cent of total sales: * from NRA Full Service

Low	16.4%
Medium	20.4%
High	28.9%

b. Alcoholic Beverage Cost Per Cent * from NRA

Low	25.0%
Medium	26.0%
High	28.1%

5. National Restaurant Association – <u>Industry Operations Report for 2000</u>

Where It Came From	Full Service	Limited Service
Food Sales	79%	96%
Beverage Sales	21%	4%
Where It Went		
Cost of Food Sold	28%	31%
Cost of Beverages Sold	6%	1%
Salaries and Wages	31%	31%
Employee Benefits	4%	2%
Restaurant Occupancy Costs	6%	7%
Other	19%	23%
Pre-Tax Profit	6%	5%

This page left intentionally blank.

Appendix 7

CITATIONS AND RESOURCES

Change to TRDA and TRAC, and EmTRAC Agreements:
Announcement 2000-22, 2000-19 I.R.B. 987
Announcement 2000-23, 2000-19 I.R.B. 992
Notice 2000-21, 2000-1 C.B. 967
Notice 2000-19, 2000-1 C.B. 973

Change of Accounting Methods - Inventory:
Rev. Proc. 2000-22, 2000-1 C.B. 1008
Rev. Proc. 2001-10, 2001-2 I.R.B. 272

Single-Member LLC's Obtaining its own EIN:
Notice 99-6, 1999-3 I.R.B. 12

Indirect Methods - Specific Identification:
Ketler v. Commissioner, T.C. Memo. 1999-68

Indirect Methods - Bank Deposit:
Ng v. Commissioner, T.C. Memo. 1997-248

Indirect Methods - Net Worth Method:
Michas v. Commissioner, T.C. Memo. 1992-161

Indirect Methods - Percentage of Mark-up
Cebellero v. Commissioner, T.C. Memo. 1990-618, ***aff'd***, 967 F.2d 986 (4th Cir. 1992)

Package Design Costs:
Rev. Proc. 97-37, 1997-37 I.R.B. 15
Rev. Proc. 98-39, 1998-2 C.B. 198
Revenue Ruling 89-23, 1989-1 C.B. 844
RJR Nabisco, Inc v Commissioner, T.C. Memo 1998-252

Intangible Assets:
Walsh v. Commissioner, T.C. Memo. 1988-242, ***aff'd***, 884 F.2d 1393 (6th Cir. 1989)

Employment Tax Cases:
McQuatters, v Commissioner, T.C. Memo. 1973-240
Fior D'Italia, Inc. v United States, 242 F.3rd 844 (9th Cir. 2001), ***petition for cert. filed***, (U.S. Sep. 14, 2001)(No. 01-463).

This page left intentionally blank.

Appendix 8

RESTAURANT BROCHURES, POSTERS, PUBLICATIONS, AND FORMS

TIPS BROCHURES

- Publication 1872 Catalog Number 22209J
- Publication 1875 Catalog Number 22212G
- Publication 1872 Mandarin catalog 22210K (Chinese)
- Publication 1872SP Catalog Number 22211V (Spanish)
- Publication 1244 Catalog Number 44472W
- Publication 1244-PR Catalog Number 63181M (Spanish)
- Form 8846 - Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips

ES&TG BROCHURES

- Document 9098 (Rev. 12-1999) Catalog Number 15624K

TIPS POSTERS

- Pub 3551A, Catalog Number 28811J - "Reporting all Your Tips May Increase your Unemployment Benefits and Worker's Compensation"
- Pub 3551B, Catalog Number 28812U - "I've got some tips for you…"
- Pub 3551 Catalog Number 28810Y - "Log Your Tips"
- Pub 3551C, Catalog Number. 28813F, "Reporting All Your Tips Adds Up"

PUBLICATIONS

- Publication 454 (Rev. 1-00) Catalog Number 63169E - Your Business Tax Kit (includes SS-4, 1040ES, 9770, Pub 1, 509, 583, 910, 1544)
- Publication 531 - "Catalog Number 15059V - Reporting Tip Income.

FORMS

- Form 8027 - Employer's Annual Information Return of Tip Income and Allocation of Tips – Catalog Number 61013P
- Form 8846 - Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips – Catalog Number 16148Z
- Form 4137 - Social Security and Medicare Tax on Unreported Tip Income – Catalog Number. 12626C
- Form 3800 - General Business Credit

Appendix 9

INTRANET AND INTERNET RESOURCES

General Sites:
Financial Accounting Standards Board (FASB) www.fasb.org
America Institute of Certified Public Accountants (AICPA) www.aicpa.org
National Association of Enrolled Agents www.naea.org
National Association of Tax Practitioners www.natptax.com
Tax and Accounting Sites Directory www.taxsites.com
Tax Links www.taxlinks.com
Tax Sites www.taxresources.com
The CPA Journal www.cpaj.com
Association for Accounting Adm. www.accountingnet.com
American Bar Association ("Section of Taxation") www.abanet.org/tax/sites.html
Rutgers Resources www.rutgers.edu
Wall Street Journal www.wsj.com
Internal Auditing www.bitwise.net/iawww
BigCharts.com (investment charting and research) www.bigcharts.com
Hoovers Online, Business Information Authority www.hoovers.com
U.S. Securities and Exchange Commission (SEC) www.sec.gov
Library of Congress www.loc.gov
Thomas Legislative Research http://thomas.loc.gov/
TCU Professor-Tax Links www.willyancey.com
Pathfinder, Your Guide to Websites of Time Inc. www.pathfinder.com
CNN News www.cnn.com
CPA Net www.cpalinks.com
ATF (Bureau of Alcohol Tobacco & Firearms www.atf.treas.gov
Food & Drug Administration www.fda.gov
Small Business Administration www.sba.gov
U.S. Department of Labor www.dol.gov
Business.com, Business Search Engine www.business.com
Money Laundering www.moneylaundering.com
Prime Time Publishing Company (Black Book Online) www.crimetime.com
Association of Certified Fraud Examiners www.cfenet.com
Department of Justice Tax Manual www.irstaxattorney.com
Small Business/Self-Employed, Employment Taxes
http://www.irs.gov/businesses/small/content/0,,id=98942,00.html

Restaurant Sites:
Nations Restaurant News www.nrn.com
National Restaurant Association www.restaurant.org
Restaurants & Institutions www.rimag.com
Food Institute, Other Food Industry Resources www.foodinstitute.com/othrlink.htm
Wine Institute www.wineinstitute.org
World Food & Beverage Report www.foodtrends.com
Thomas Food Industry Register www.tfir.com

Retail Technology Newsletter www.retailtech.com
National Bar & Restaurant Management Association www.bar-restaurant.com
Restaurants for Sale - World Wide www.restaurants-for-sale.com
Restaurant Listings: www.cuisinenet.com
www.kerrymenu.com
www.restaurant-pages.com

Appendix 10

BIBLIOGRAPHY

1. Hynes, Ed, CPA; Matysik, Walt. Restaurant Accounting and Controls 2000, Edmonds, WA: Restaurant Seminar Institute, Inc., 2000. 800-526-5798 or 425-673-8748. www.restaurantseminars.com

2. National Restaurant Association; Deloitte & Touche. Restaurant Industry Operations Report 2000. Washington, D.C.: 2000. 800-424-5156, ext. 5960.

3. Hynes, Edward M, CPA; Matysik, Walt K; Shipp, Cherie W, CPA. Restaurants and Bars Vol. I and II. Fort Worth, Texas: Practitioners Publishing Company, Tenth Edition (October 2000). www.ppcnet.com 800-323-8724.

4. Biebl, Andrew R., CPA; Esch, John B., JD, CPA; Mares, Michael E., JD, CPA; McMurrian, Sara S., CPA; Ranweiler, Robert J., CPA. Specialized Industry Tax Guide, Vol. I and II. Fort Worth, Texas: Practitioners Publishing Company, Second Edition, August 2000. www.ppcnet.com 800-323-8724.

5. National Restaurant Association. Uniform Systems of Accounts for Restaurants. Washington, D. C.: Prepared by Deloitte & Touche, LLP, 1996. 800-424-5156 or 202-331-5960.

6. Stefanelli, John. The Sale and Purchase of Restaurants. William F. Harrah College of Hotel Administration, University of Nevada, Las Vegas: John Wiley & Sons, Inc. 1990.

7. IRS Food Industry Guide. Published July 2000.