

CASH-INTENSIVE BUSINESSES

Cash transactions are anonymous, leaving no paper trail behind. Businesses that deal heavily in cash are naturally susceptible to underreporting. As a result, they are heavily targeted by the IRS for audits. This guide discusses many of the techniques that the IRS will use if they are auditing your cash-intensive business.

Pre-audit analysis

Before contacting you to initiate the audit, the examiner will review your tax return for potential areas of abuse. This includes analyzing your cost of living and comparing it to the amount of income you are reporting. Some of the questions the examiner will consider include:

1. Do you live in an expensive area, disproportionate to the amount of income you reported?
2. Is your occupation one that could have indirect sources of additional income?
3. Could the amount of income you are reporting support a family of the size reflected on your return?
4. Does the tax return indicate the existence of foreign bank accounts?
5. Are the property taxes listed on Schedule A excessive, indicating that you may own additional property?
6. Do you have a large amount of interest expense, which could indicate a large amount of indebtedness inconsistent with your level of income?
7. Are there any unusual large expenses, such as gambling losses?
8. Was interest or dividend income reported? If not, should it have been? If it is reported, is the amount consistent with the level of income?
9. If property was bought or sold, what was the source of funds, or where were proceeds reinvested?
10. Is the gross profit percentage consistent with other businesses of your size in your industry?
11. What method was used to compute gross income?
12. What are the internal controls in place for collecting cash? How are cash receipts recorded? Are all cash receipts deposited on a daily basis?
13. Does the number of cash registers, employees, or equipment indicate that more business is going on than what is being reported?

The examiner may also review public records and gather additional information about your business from sources such as federal agencies, court records, state records, credit reports, insurance providers, trade associations, and suppliers.

Initial Interview

After conducting a pre-audit analysis, the examiner will have identified several areas to focus on during the course of the examination. The next step is usually to issue an Information Document Request (IDR), which asks for information and documents related to the items that are under examination. Common items that are requested include things like general ledgers, receipts, and bank statements, but each IDR is different.

The examiner will also schedule an interview with you. The purpose of this interview is to gain an overall understanding of your financial picture and how your business operates. Questions are likely to focus on your business's recordkeeping practices. These interviews can result in the examiner either narrowing or expanding the scope of the audit. An interview for a cash intensive business can sometimes take two or more hours.

The examiner will want to learn about how cash is handled at the business, from the moment it is received until it is either deposited in the bank or spent. Similarly, the examiner will want an explanation of the process used to pay expenses with cash, including the names of individuals who are authorized to pay out cash and where the cash comes from.

Cash on Hand

The examiner will ask about cash-on-hand that you have access to, which includes funds that are available from friends, relatives, or related businesses. It also includes any cash that is kept in a safe or any other location.

Business History

The examiner will want to piece together the history of your business, as well as any related businesses. This includes performing a comparative analysis of multiple tax years. If your business consistently shows losses or low profits, the examiner will want an explanation of what is causing the problem and what steps have been taken to improve financial performance. If there is no explanation, the examiner may suspect that you are underreporting your income.

Financial Information

Statements for all accounts will be requested, including personal accounts, certificates of deposits, and other forms of money deposits. Records pertaining to personal loans to others, including relatives, will also be requested, as the examiner tries to obtain a full picture of your financial situation.

Interview Questions

The purpose of the initial interview is to obtain an overall understanding of your business. The examiner will seek to gather as much information as possible. The examiner will follow up on any discrepancies in your answers. Questions that will be asked during the initial interview may include the following:

1. What are your principal products or services?
2. How long have you been in business?
3. Who are your principal customers?
4. Do you have any other sources of income?
5. How are sales handled at your business?
6. Is your accounting on a cash or accrual basis?
7. If you are on the accrual basis, do you have a list of accounts payable and receivable?
8. How are your prices set?
9. What is your markup percentage on each product or service?
10. How often is inventory taken, and who takes it?
11. Who maintains the books, and where did this person learn recordkeeping?
12. What bank accounts do you maintain?
13. Is all cash deposited? Who makes these deposits, and how often?
14. Are expenses paid with cash? If so, what is the process for that?
15. Do you ever convert checks to cash, rather than depositing them?
16. Do you make personal withdrawals from the business accounts?
17. Do you have a safe deposit box?
18. How are expenses recorded?
19. How were the figures on the tax return computed?
20. How much cash do you have on hand? Where is it located?
21. Do you have any non-taxable income?
22. Do you have any pensions, loans, gifts, or inheritances?
23. Do you have any investments, including stock or real estate?
24. Did you acquire any assets? When and how?
25. What is your educational background?

Issuing a Summons

If you have inadequate books and records, the examiner may issue summons on third-parties for records, including banks, vendors, suppliers, accountants, and brokers. If you are uncooperative, the examiner may also issue a summons on you, so that you can be asked at a summons hearing whether you have any additional accounts that have not been disclosed, as well as any other sources of income that are not already disclosed.

Income Probes

Examiners are required to perform certain minimum tests to determine whether you accurately reported your income. Depending on the results of these initial tests, further investigation may be pursued.

1. Financial Status Analysis

The examiner will first develop a Cash-T analysis based on the tax return and information contained in the case file. The examiner will also use information from prior and subsequent years to perform a comparative analysis.

If there is a significant imbalance in the cash flows, the examiner will bring it to your attention and give you a chance to explain the discrepancies. Imbalances could be caused by nontaxable income, such as gifts, inheritances, or loan proceeds.

The information gained during the interview will play a role in this analysis. Examiners may ask for information such as:

1. Whether you withdraw good from your business for personal use, and if so, whether you track these withdrawals for purposes of calculating your cost of goods sold.
2. Whether you received any merchandise, trips, or prizes from vendors or suppliers for bulk purchases.
3. Whether employees get discounts, and how such discounts are accounted for in the books.
4. Whether there are any secondary or sideline businesses that generate income.
5. Whether there were any bartered transactions that are not reflected in the books.
6. Whether you have any cash hoards. If so, the examiner will want to know where it came from. They may suspect that it was skimmed from the business, in which case it is taxable.

2. Tour of the Business

Examiners may also request a tour of the business. This is usually done in conjunction with the initial interview. During the tour, they will likely observe how business transactions are conducted, including how frequently transactions are conducted with cash. They will take notes of the prices that are charged for particular items, then compare these to records for the year under audit, to ensure that prices were not lowered after coming under audit.

They will also look to see if there are any additional sources of income, such as vending machine, newspaper stands, or phone cards for sale. They will note if there are any vaults or

safes on the premises, their size, and who has access to them. They may contact the manufacturer of your POS system to determine what types of reports and records could be accessed.

3. Evaluate Internal Controls

The examiner will review the internal controls in place to assess the reliability of your books and records. The fact that your books match the figures on the tax return is not enough to establish that the books are reliable. A flowchart of your internal controls will be prepared. Where multiple individuals are involved in the process of receiving and recording income, there is lower potential for abuse or underreporting.

4. Test Gross Receipts

Once the income is reconciled to the books, the examiner will test the income that is included in the books by tying the original source documents to the amounts reported on the tax return. Original source documents include invoices and cash register receipts. If original source documents are missing, other methods may be used. For example, the examiner may try to match expense items to corresponding income, to ensure that income is being accurately reported.

5. Analyze Bank Accounts

The examiner will want to review all account statements, both business and personal. This includes any investment accounts and CD accounts. The examiner will look for the frequency of deposits and note any unusual deposits, either by size or by source.

If total deposits in the accounts exceed the gross receipts of the business, it may indicate that either business receipts are being spent rather than deposited, or that the business receipts are not being accurately reported. If expenses paid by check are less than the amount of expenses that are being deducted, the examiner may suspect that you are inflating expenses, paying expenses by cash (without reporting the cash as income first), or paying expenses from an undisclosed source of income. Commingling of business and personal funds indicates that internal controls are weak, which may result in further analysis.

6. Analyze Business Ratios

In evaluating the reasonableness and accuracy of books and records, examiners will use ratios. These include gross profit percentages and inventory turnover. If these ratios are inconsistent, the examiner may suspect misreporting.

7. Analyze E-Commerce Activity

The examiner will likely ask if you have a business website. If so, the examiner will check to see if your site has any advertisements that could be potential sources of unreported income, or if there are internet sales that could potentially go unreported.

8. Test Gross Receipts

The cash receipts reported will be compared to the bank deposits. If there are discrepancies, you will be asked to provide an explanation. Other indications of misreporting include excessive voids, no sales, and refunds. If the cash register is frequently opened without a transaction being recorded, unreported sales will be suspected.

All numbered invoices will be reviewed. If invoices are not numbered, you will be asked to explain how you are sure that every invoice is present.

Examination Techniques

Examiners will use several techniques to identify unreported income. The most common method of not reporting cash income is to simply skim cash prior to its entry into the accounting system. As a result, the books appear to be consistent with the figures on the tax return.

One method to detect unreported cash income is to review purchases by the business. For example, if smog certificates are required for each vehicle sold, the number of smog certificates purchased will reveal the number of vehicles sold. If the number of vehicles reported to be sold is less than the number of smog certificates purchases, the examiner will need to either see the missing data, or the missing data can be calculated by multiplying the number by the average of the reported sales. Other sources of information may include the following:

1. Records provided to a potential buyer of the business.
2. Records provided to a lender.
3. A disadvantaged spouse (or former spouse) may provide information about the cash flows and whether there are any hidden assets or sources of income.
4. Mistreated employees (or former employees) may provide information.

Indirect Methods

There are direct methods for calculating income, such as obtaining deposit slips or invoices.

When direct methods are not available, examiners will use indirect methods, based on circumstantial evidence.

Percentage of Markup Method

Under this indirect method, examiners can calculate a business's gross profit by multiplying the amount of goods purchased by the usual markup percentage. If your business's markup percentage cannot be determined, the examiner may use standards obtained from various sources, such as the Bureau of Labor Statistics or publications specific to your industry. Cases where the markup method is considered include the following:

1. Where inventories are the principal income-producing factor.
2. Where cost of goods sold or merchandise purchased are from a limited number of suppliers.
3. Where suppliers can be determined with reasonable certainty.
4. Where the per unit sales price can be determined with reasonable consistency.

Percentage Computation Methods

If the gross profit percentage for your industry is relatively consistent, the examiner will compare your gross profit percentage to industry averages. Factors the examiner will consider include type of merchandise, the size of your operation, the location where you operate, the periods that are being examined, as well as your particular policies that could influence your profit percentage.

If there is a percentage relationship between sales and a particular expense, then this could also be used to calculate gross income. For example, if your business pays a 3% commission to employees for sales, the amount of commissions paid to employees for the year can be used to calculate the total sales.

Unit and Volume Markup Method

Where the examiner knows the number of units produced or purchased, as well as the price or profit per unit, this information can be used to calculate gross income. The problem with this method is that it does not consider things like test units (which are never sold) or waste. The examiner may also apply an industry standard that does not necessarily apply to your business. Deviations from industry norms are not alone sufficient to justify an in-depth examination of your income using indirect methods.

Fully Developed Cash T Account Method

This method lists all of the different types of cash income you have and all known cash expenditures. If the expenditures exceed the income, the examiner will assume that you have either underreported your income or inflated your expenses.

Source and Applications of Funds Method

Rather than considering the inflows and outflows of cash, as the previous method does, the source and application of funds method considers changes in assets and liabilities. If the funds applied exceed the sources of funds, the examiner will assume there is an underreporting of adjusted gross income. This method is more time consuming and usually requires that you have a statement of assets and liabilities available.

Bank Deposit and Cash Expenditure Method

This method compares your total deposits and cash expenses minus nontaxable income to the total receipts that are shown on your tax return. This method is not favored for cash intensive businesses, because it is only useful if all receipts are deposited into the bank, and the examiner can accurately determine your personal living expenses. The idea behind this method is that the total amount of income received can be determined by showing how it was spent.

Net Worth Method

Examiners may also evaluate your net worth, by calculating the value of you assets and liabilities. A comparison of your net worth at the beginning of the year and end of the year can show your income for the year. In order to arrive at an accurate number, the examiner must subtract nontaxable income from the calculation, while adding in non-deductible expenditures.

Examination Techniques to Corroborate or Refute Claims of Non-Taxable Income

The examiner may use some of the following techniques in order to corroborate or refute your claims that certain income is non-taxable:

1. Ask you for specific dates when a specific amount of money was received from friends or family. A vague statement that a friend or family member gave you money is not enough.
2. Check to see if a loan can be verified by any other sources.
3. Check the lender's records to see if the related withdrawals are shown in bank statements.
4. Check to see if proper FinCen forms were filed for large currency transactions, or if currency was brought into the country.

5. Look to see what was done with the currency after it was received on that day. An examiner will be suspicious if you claim that you borrowed money only to keep it in a drawer for several months and never deposit it into the bank.
6. If foreign currency was converted to dollars, look to see if there are any records of this exchange.
7. Obtain contact information of anyone who provided cash loans, then contact these individuals for proof, including requesting copies of their tax returns.

If you are unable to provide specific information, the examiner will doubt your credibility. For example, if you received a cash loan, you would need to know how much the loan was for, so that you can pay it back. You would also need to know the date it was borrowed, so that interest can be properly calculated. In the case of a loan, the examiner will also want to see if you have started repaying it.

If the loan is from a friend or family member, they may also be interviewed. The examiner will ask them for similar information, such as the specific amount of loans and the dates on which the loans were made.

Net Operating Loss and Passive Activity Loss Considerations

The Net Operating Loss Deduction (NOLD) permits you to offset your losses from one tax year against profit from other years. Whenever there is a net operating loss, the examiner will ask questions. If you report a net operating loss, yet you are able to pay all of your personal expenses for the year, you will be asked to explain where you got the funds to pay those expenses.

If your business reports a string of losses over several years, you will be asked to explain what is causing the losses, what has been done to correct the problem, and why you remain in business despite consistently experiencing losses.

Employment Tax Issues

When auditing a business, examiners will look to see if any required employment tax returns have been filed, such as the annual Form 940 and quarterly Form 941. They will also consider the issue of whether workers are properly classified. Often, businesses will improperly classify employees as independent contractors, in order to avoid paying employment taxes.

Cash Hoard

The examiner will want to establish the amount of cash you have on hand during the initial interview. This includes any cash that is not held at a financial institution. If the amount of cash

is significant, the examiner will likely ask to see where it is kept.

DIGITAL CASH AND ELECTRONIC MONEY

Digital currency has grown in popularity recently, and it is used by many for abusive purposes, including tax evasion. In response, the IRS has worked to develop methods to detect transactions conducted in digital currency, including PayPal and E-gold.

Detecting the Use of Digital Cash

The first step to detecting the use of online currency is to review bank statements, which is done during all audits. If the statements show debits to online companies, such as PayPal or E-gold, the examiner will investigate further. If there are any questionable transactions, you will be asked to explain where money is being sent. If your explanation is inadequate, or the examiner does not believe it is credible, they will contact your financial institution or credit card company for more information about the transactions in question.

Audit Techniques

Examiners will use the following techniques to detect digital cash:

1. Treat all credit cards like individual bank accounts and track what goes in and comes out.
2. Identify transactions and determine whether they are reasonable. For example, if a low income taxpayer has a membership at a country club, the examiner will be suspicious.
3. Analyze your overall net worth, including investments and real property holdings, to assess whether the amount of income you are reporting is consistent with someone of that net worth.
4. Review your cash disbursements journal for a period of time to see if there are any missing check numbers. If there are, the examiner will check to see if checks were written for expense that were later deducted, with the check never actually being issued or cashed.
5. Review cash receipts journal for any entries that suggest the sale of an asset or a potential source of unreported income.

UNDERGROUND ECONOMY

The underground economy refers to income that is earned “under the table,” without being reported to the IRS. To detect underground workers, the IRS looks for certain traits, including the following:

- Using a PO Box, rather than a personal address.
- Dealing exclusively in cash.
- Not maintaining bank accounts, or not using bank accounts for any significant transactions.
- Using an answering machine to screen calls.
- Owning a safe.

Audit Techniques

The following techniques are typically used by examiners to detect underground workers:

- Comparative Analysis of assets and interest- Accumulation of cash could be identified by performing a multiple year analysis of your assets and interest expense. If there is an increase in assets without additional indebtedness, the examiner will suspect there are hidden funds.
- Barter Activity- It is common for goods and services to be traded in the underground economy. The goods or services that are received as part of a barter transaction are taxable income.
- Test Checks Written- They will review your statements to see if normal expenses are accounted for, such as rent/mortgage, utilities, and food. If these expenses do not appear in your statements or checks for each month, the examiner will conclude that you are using cash, or that there are additional accounts that you have not disclosed.
- Cash Transaction Report- They will check your cash transaction history for prior or subsequent years, to determine the level of income that was available, and how it was spent.
- Loan Applications- If you applied for loans, the examiner will look to see the amount of income claimed on the loan application, as well as the source of such income.
- Civil, Criminal and Family Court- Examiners may search for court records that list assets and income, such as divorce records.
- Third Party Contacts- The examiner may contact business associates, creditors, and former spouses to ask about your business and sources of income.

BAIL BOND INDUSTRY

Bail Bond Defined

This industry tends to be very cash intensive, since they prefer to collect cash from clients, rather than checks of other forms of payment. Gross receipts are typically 50-80% cash.

Books and Records

Bail bond businesses are required under state law to maintain certain records, including many that are unique to the industry. These documents will generally be requested in the examiner's initial Information Document Request:

1. Numbered weekly reports to surety companies
2. Canceled checks for bond costs and BUF payment
3. Bank statements/accounts
4. Income receipts
5. Collateral receipts
6. Invoices for blank bonds from the surety company
7. Bail agreement
8. Surety contract

Internal Information Sources

The IRS can access information through the Currency Banking Retrieval System (CBRS), which tracks cash transactions exceeding \$10,000. The two most common forms that are filed are Currency Transaction Reports (CTR) and Form 8300.

Third Party Sources

Information from the state's department of insurance provides the examiner with a general profile of your business. Information such as the date your bail license was issued, the type of license, the number of employees, and whether or not you have any partnership can usually be provided. They may also provide a list of surety companies that you have worked with and the dates involved. Surety companies may also provide the IRS with information regarding your income and expenses.

Initial Interview

The initial interview is a very important part of the audit. The examiner will seek to determine how involved you are in the daily operations of your business, what types of records you keep, and what internal controls are in place, particularly when dealing with cash. Here are some questions that you can expect to be asked, with respect to cash transactions:

- Who handles cash?
- Who deposits cash?
- How often are deposits made?
- Is all cash deposited?
- What types of collateral do you accept?
- How is collateral handled?
- If the collateral is cash, where is it deposited?
- Do you keep separate accounts for operating funds and collateral?
- Was any collateral seized or retained?
- Are expenses paid in cash?

- Are you aware of the Form 8300 filing requirements?

Required Filing Checks

Examiners will always check to see if any employment tax issues exist. This includes checking Forms W-4 for accuracy and making sure that all information returns were filed for the periods under audit. During the initial interview, they will ask questions about your Form 8300 filing requirements, including whether you are aware of such requirements, and when you became aware.

Gross Income

Since unreported income is a common issue in cash intensive businesses, the examiner will perform a thorough income probe. Indirect methods will be used to gauge whether the amount of income you reported is reasonable.

Since up to 80% of receipts in this industry are cash, bank deposit is not a good method for calculating income. However, bank statements will still be reviewed, as they may reveal additional sources of income.

Establishing Fraud

The cash intensive nature of this industry increases the likelihood that not all income will be reported, and that not all cash receipts will be deposited. Collateral that is retained often is not reported, as well as real estate seized to pay a summary judgment.

To detect unreported income, examiners will use indirect methods, such as the Source and Application of Funds Method, the Net Worth Method, and the Bank Deposit and Cash Expenditures Method. Each of these methods focuses on the use of funds.

Examiners will also perform a thorough asset search. A search of the Department of Motor Vehicle Records may reveal vehicles that were used as collateral and ultimately retained. County Records can reveal the acquisition of real estate. The examiner may also request a tour of your residence and place of business, which could turn up assets that you have not previously accounted for.

BEAUTY AND BARBER SHOPS

The salon industry is cash intensive, and there are often limited books and records. As a result, examiners will seek to gather the bulk of their information by interviewing you, evaluating your standard of living, and using an innovation method of determining your income.

Tour of Business:

The examiner will ask to tour your business and will make note of the different goods and services that are offered, as well as the number of work stations, posted prices, appointment procedures, and payment procedures.

Salon Income

The examiner will ask how workers are compensated. If workers are compensated based on commission, for example, then the amount of commissions paid can be used to calculate the income received by the business.

The following information is needed to calculate income using this method:

1. Employee commission percent
2. Owner's activity in salon
3. Wage expense from the tax return
4. Service Income from tax return

Retail Income

There are two methods in reconstructing retail revenue. The first is based on Cost of Goods Sold (COGS). It is common for salons to mark-up products 100%. To calculate retail income, the examiner will multiply the COGS by two.

A second method for reconstructing retail revenue is based on commissions. Stylists are commonly paid 10-15% commission when they sell products to customers. The examiner will likely ask about this percentage when you are interviewed. If commissions are paid, the examiner can use the total amount of commissions paid to estimate the total income from retail sales.

Rental Income

Another potential source of income in this industry is rental fees. When stylists are independent contractors, they typically pay fees for booth rentals. If all stylists are employees, then there will not be any rental income.

Appointment Book

The appointment book can be very useful to the examiner when probing income. The examiner will typically review a day in the appointment book with you to get an understanding of the procedures. This includes learning about any coding system you have in place to indicate the type of service that an appointment is for. An important step in the examination is to compare the type of services and the number of appointments to the total amount of income reported. If you maintain a daily income summary, the examiner will also want to review it and compare it to the appointment book.

Employee vs. Independent Contractor

Another big issue in audits of salons is the classification of workers. The use of independent contractors is common in this industry. Often, however, businesses improperly classify workers as independent contractors in order to avoid paying employment taxes. Simply

labeling a worker an independent contractor does not legally make them one. To determine the proper classification, examiners will apply a twenty factor test, with the overriding factor being the amount of control the business has over the manner in which the worker performs the work. During the initial interview, the examiner will likely discuss with you the reasons the workers are treated as independent contractors.

Calculating Unreported Tips

On the initial information document request, the examiner will request tip records. If you do not provide any tip records, tip rates can be determined based on charge slips, interviews, industry practice, and observations.

Initial Interview and Information Document Request

Examiners will likely ask some of the following questions during the initial interview:

Rental Revenue (Booth Rentals)

1. How many stations do you have in the salon?
2. How many different locations does your business have?
3. How many types of stations do you have?
4. How many of each type of station do you have?
5. Are these stations leased?
6. If the stations are leased, what percentage was occupied during the year under audit?
7. Is the rental fee fixed or based on a percentage?
8. Is the fee for the booth rental the same for all cosmetologists?
9. What was the rent for each of the stations rented out?
10. Are there written lease agreements?
11. In addition to the stations, do you also provide supplies? If so, do you charge a fee for this?
12. Are there written service contracts with the renters?
13. Who pays the State's revenue tax on the station?
14. Who is responsible for the general liability, malpractice or worker's compensation insurance's on the station?

Service Revenue

1. How many employees do you have?
2. What are the appointments procedures?
3. How are the employees paid?
4. Do you have tanning beds? How many?
5. Do you have facial tables? How many?
6. What are the different sources of revenue that you have?
7. What times of the year are busy, and what times are slow?
8. Do you accept walk-ins? If so, what percentage is walk-ins?
9. How do walk-ins, cancellations, and no shows appear in the appointment book?
10. What is the customer tracking system?
11. Do you keep customer cards?

12. Is there a daily/weekly report for each worker?
13. What are your inventory procedures?
14. What services does the shop offer and what are the standard prices?
15. Are there different prices for each stylist?
16. Do you accept coupons? What percentage of customers uses coupons?
17. Do you offer any discounts, such as for senior citizens or members of the military?
18. What are the appointment procedures? How do customers make appointments?
19. How are walk-ins, cancellations, and no shows designated in the appointment book?
20. Other than the appointment book, what recordkeeping systems are in place?
21. How are different types of services coded in the appointment book?
22. Do you sell gift certificates? How are they accounted for?
23. What days and hours are you open?
24. Do you close for holidays?
25. What are each worker's responsibilities?
26. How is each worker compensated?
27. How are tips accounted for?
28. Do you perform any services yourself? If so, what types?
29. Do you have a separate appointment book from other stylists?
30. Does the business provide off-site services? If so, what services are provided and what are the fees for the services rendered off-premises?
31. Does anyone at the salon have any specialty licenses (e.g., pedicure, manicure, facials, hair restoration, massage therapy, etc.)?

Owner

1. How many days a week do you work?
2. What types of services do you personally provide?
3. How often are the appointments booked?
4. What are the requirements for license renewal?
5. What CPE courses and other training did you take during the year?
6. What tradeshow, seminars and/or conferences did the owner attend during the year? Where were they held?
7. Did any of the other workers attend conferences, seminars, or trade shows? If so, did you pay their expense?

Retail Revenue

1. Do you sell products?
2. What types of products do you sell?
3. What is the percentage mark-up on products?
4. What is the gross profit percentage on products?
5. How often are products sold to customers who do receive services at the salon?
6. Are commissions paid to those who sell products? What percentage?
7. Who is the supplier of the products?
8. Do you have your own line of products?
9. Do you ever run sales on products? If so, how are they accounted for?
10. Do you accept manufacturer's coupons? How are they accounted for?
11. If commissions are paid, are they reflected on Form W-2 or Form 1099?

Employee vs. Independent Contractor

1. How many receptionists are employed?
2. Do workers pay rent?
3. Who is responsible for damage to the chair?
4. Do the workers pay a maintenance fee for their booth?
5. Does each worker maintain his or her own appointment book?
6. Who collects the money earned by the worker?
7. Who pays for each worker's supplies?
8. Who maintains the books and records for each worker?
9. Who pays for the phones?
10. How many phone lines are there?
11. Are there any manicurists? How are they paid?
12. Are there any workers who only wash hair?
13. How do you pay your assistants?

Information Document Request

The following records are likely to be requested in the examiner's initial Information Document Request:

1. Appointment Book(s)
2. Schedules for workers
3. Cash box receipts
4. Copies of service slips
5. Lease agreements for booths/stations
6. Any franchise fee agreements
7. Completed Form 4822
8. Customer cards/files
9. Salon's price schedule/chart;
10. Insurance policies
11. Daily income summaries
12. Tip diaries
13. Service contracts on booth rentals (e.g. phone costs)

CAR WASHES

Pre-Audit Analysis

Prior to the audit, the examiner will try to become familiar with you and your business. To assess the audit potential, examiners will review the numbers on your tax return and perform a ratio analysis to compare to industry averages. They can also use information from third parties, such as the Department of Motor Vehicles, Tax Assessor's and Collector's Offices, County Deed Records, the local water department, your electricity provider, soap and chemical manufacturers, equipment manufacturers, and the National Weather Service.

Audit Techniques

Income - Gross Receipts

Since car washes are cash intensive businesses, an important part of the audit will be probing the gross receipts. Many business owners simply add all of the deposits in their business account to calculate gross receipts. However, as with all cash intensive businesses, it is possible that some of the cash received was not ever deposited. Examiners will review information from various sources to assess the accuracy of gross receipts that are reported, such as the following:

1. Daily Sales Summary Sheets
2. Car Counters
3. Income from self-service activities (e.g. vacuuming, vending, etc.)

Consumption Methods

In addition to reviewing your books and records, the examiner may try to estimate your gross receipts by analyzing your consumption. For example, they may try to calculate the number of cars that were washed based on the amount of water (or soap or chemicals) consumed. To use this method, the examiner must determine an accurate estimate of the average amount of water used per wash.

Expenses

The IRS has identified the expenses below as areas where adjustments are commonly made during an audit.

Wage Expense - Employee vs. Independent Contractor

Many times, business owners will incorrectly classify employees as independent contractors, in order to avoid paying employment taxes. If you use independent contractors, the examiner will likely use a twenty factor test to determine whether they should be reclassified as employees. The overriding consideration in this test is how much control you have over the worker and how the work is performed.

Another issue is officer compensation, if your business is a corporation. Many people do not realize that the officers of a corporation are statutory employees, meaning they must be paid a reasonable salary. In determining whether the salary is reasonable, the examiner will consider the officer's involvement in the business, how the salary was determined, performance of the company, the shareholder loan account, and the dividend history.

Repairs

Car wash equipment, whether new or used, generally requires ongoing maintenance and repair to keep it in good working order. Therefore, the amount of repair expenses that are claimed could be significant. The examiner will review these expenses to ensure that they are not

actually capital expenditures, which are depreciated over time, rather than fully deductible in the year incurred.

Rents

If you own the land and building, but rent it out to the car wash entity, this is referred to as “self-rented property.” Due to the passive activity rules, losses that result from this rental activity are generally disallowed, though income is taxable.

Another issue that will be reviewed is whether the amount of rent being charged is reasonable. Rent that is in excess of fair market value may be reclassified a dividend distributions to you. Examiners may contact a local public appraiser or real estate agent to assess the fair rental value, or they may search the internet.

Depreciation

The examiner may want to review contracts related to the purchase of buildings or equipment, and other documents related to asset acquisitions, in order to assess whether the proper amount of depreciation expense is being claimed. They will also look to ensure that the proper “useful life” is being used.

Insurance

By inspecting your insurance policies, the examiner may discover acquisitions or sales of assets not reflected on the tax return.

Shareholder Loans

Loans that you make from the business to yourself are likely to be scrutinized, to see if they should be reclassified as constructive dividends. Loans that are made to affiliates will similarly be scrutinized

Potential Interview questions

1. How much time do you personally spend at the business?
2. How many locations are there?
3. How many bays are there?
4. What services are provided?
5. What is your price scale?
6. Do you charge more for certain types of vehicles?
7. What percentage of your customers purchase each type of wash (e.g. basic, premium, etc.)?
What are your busy and slow seasons?
Do you have a water reclaim system?
Do you use public or private water sources?
How many water meters are on the property?
How many gallons of water are used for each type of wash?

What are the types of soaps and other chemicals that are used, and in what quantities are they purchased?

Are any of these chemicals or other products used on every single car that comes in?

How many cars can be serviced using a single unit of soap (or other chemical or product)?

How often do you wash down bays or tunnels?

Do you have a "Weep" system? If so, at what temperature does it engage? How many gallons of water are used? Is the water tied into a reclaim system?

Were there any significant leaks or water losses?

Do you know how many kilowatts of electricity are used per wash?

Is your equipment personally manufactured, or is it commercially produced?

If commercially produced, who is the manufacturer of the equipment?

When was the equipment purchased, and how is it depreciated?

Who performs maintenance and repairs?

Do you keep separate tallies for each collection bay?

How do you account for coupons, discounts, and rewashes?

Are coins deposited or exchanged in the coin changer?

Where is money kept after collection?

Are there car counters?

When and where are expenses recorded?

How is cash handled?

Do you accept credit cards?

Do you ever barter?

Information Requested

The following information and documents are likely to be requested in the initial Information Document Request (IDR):

- Water and sewer bills which reflect monthly meter readings for the year under audit.
- Electric bills which reflect monthly meter readings for the year under audit.
- For equipment, the date, cost, name, and address of the manufacturer, model or serial number, and name and address of the installer.
- List of all soaps, chemicals, or other products that are used, as well as amounts on hand at the beginning and end of the year.
- Car counter records, if available.
- Any information related to the issuance and acceptance of discount coupons.

COIN-OPERATED AMUSEMENTS

Tour of the Business

Examiners typically tour cash intensive businesses to observe operations and determine how cash is handled, the types of records that are kept, as well as whether there are any additional sources of income that are not reported. Often, coin-operated amusements are discovered during a tour of a business.

If coin operated amusements are discovered, examiners will wonder:

- How they generate revenue;
- Whether they are owned or leased;
- If owned, how is the property depreciated;
- How often income is collected from the machines;
- How the income is recorded in the books; and
- Whether the income is recorded separately in the books.

Most coin operated machines have a sticker or plaque with the owner's contact information. If no income is reported for the machine, the examiner may contact the owner for more information.

Audit Techniques

Examiners typically use the following techniques when auditing issues involving coin-operated amusements:

- They will review your deposit slips on the dates that income is supposed to be collected from the machines to see if sufficient coin income is being deposited at the bank;
- They will observe your business at peak times. For example, coin-operated amusements are likely to be used when children are released from school.
- They will contact the owner of the machine for copies of any contracts that exist, and to determine reported income. If you are paid by check, they will look to see if the check is being deposited into your normal business account.

CONVENIENCE STORES

The primary issues that are reviewed during the audit of a convenience store are:

- Unreported income,
- Handling and accounting for cash receipts, and
- Cost of goods sold.

Cash and Internal Controls

The examiner will likely ask questions about how cash is handled, such as:

- Who collects the cash?
- Where is cash kept?
- How often is cash deposited?
- Who reconciles cash to sales at the end of each shift or day?

When cash is used to pay expenses, the examiner will want to know:

- Who is authorized to make cash payments?
- What is the procedure?

- How are these transactions recorded?

Audit Techniques

- The examiner will ask if you store cash or pay bills using money orders.
- They will ask if you send money orders to friends or relatives.
- They may summons your residential utility company, mortgage company, or auto loans to determine how you pay your personal expenses. They are looking to make sure you aren't using cash collected from your business to pay expenses, without reporting that cash as income.

Self-Consumed Items

Owners of these types of business typically use some of the products for personal use. After all, it would not make sense to drive down the street and purchase products from a competitor, rather than using your own inventory that you purchased at cost. The examiner will likely address this issue during the initial interview, where you will be asked to explain how these transactions are accounted for.

Audit Techniques

- During the initial interview, the examiner will ask when financial tasks are performed and recorded. As more time passes between a transaction and its recording, there is a higher risk of alterations, manipulations, or deletions.
- The examiner will ask what percentage of your sales consists of cash payments, compared to checks or credit cards.
- While touring your business, they will observe the frequency of tax transactions to determine whether it is consistent with your claims.
- They will compare the cash register tapes from the day the register was observed, to the tapes for the audit period.
- They will match your statements, cash register records, or reports, against the findings from their personal observations.
- They will calculate your average daily receipts by dividing the total reported receipts by 365. They will compare this figure to the figures from the day that the examiner tours the business, to assess reasonableness.
- They will match your cash register tapes to cash deposits for a sample period.
- They may contact state auditors or sales tax auditors for information on prior examinations and to determine what markup percentages were used.
- They may contact beer and wine suppliers to determine if the amount purchased is consistent with the reported cost of goods sold.
- They will trace credit card transactions deposited to the bank account to the cash register tapes. If the purchases cannot be found on the cash register tapes, you will be asked why.

LAUNDROMATS

Income

While a laundromat's main source of income is from coins deposited into the washing and drying machines, there are often additional sources of income, such as vending machines or laundry product sales.

The examiner may believe that your method of determining income is inadequate if:

- Records are unavailable;
- The cash T-account indicates a shortage and you cannot provide an explanation;
- Your business ratios vary from industry averages;
- Your operations indicate more income than what was reported; or
- Your reported receipts cannot be tied to the books because they were not deposited or cannot otherwise be verified.

Initial Interview and Information Document Request

The examiner will almost always tour your business, in order to observe your operations and determine whether there are any potential sources of unreported income (e.g. vending machines). It is important for them to determine the amount of cash that you had at the beginning and end of the year, as well as any sources of non-taxable income.

The examiner will count the number of units at your business and the load capacity of each. Comparing the efficiency rating of each to the amount of electricity that is consumed can allow the examiner to determine whether the amount of income you reported is reasonable.

SCRAP METAL

Purchasers of Scrap Metal

Pre-Audit Steps

- The examiner will research the Currency and Banking Retrieval System (CBRS) to see if any Currency Transaction Reports (CTR) or Forms 8300 were filed, for cash transactions exceeding \$10,000.
- They will request an interview with you or the person who is most familiar with day-to-day operations.
- They will arrange a tour of your business.

Information Document Request

The following documents are likely to be requested by the examiner:

- Weight tickets for cash purchases;
- Cash slips;

- Copies of any shippers prepared by the seller for cash purchases;
- Metal settlement reports;
- Copies of any checks that were written to cash;
- List of the names and addresses of your suppliers;
- A schedule of any cash advances made to suppliers;
- Any contracts or bids for large jobs;

Interview Questions

- What kinds of metals do you purchase?
- If you purchase nonferrous metals, what types?
- What percentage of your purchases is from each type of metal?
- In what condition is the metal that you purchase?
- What type of processing do you perform on purchased metal?
- How do you determine the price that you pay for the metal you purchase?
- What types of accounts do you handle (e.g. industrial, peddler, brokers, etc.)?
- Who handles each account?
- Who are your primary suppliers for each type of account?
- What is the process when someone comes to your business with scrap metal to sell?
- What is the process when you pick up scrap metal that you are buying?
- What percentage of your purchases is paid in cash?
- How do you obtain the cash that you use for these purchases? Is it on hand, or do you withdraw it from the bank?
- Who withdraws cash from the bank?
- What records do you keep for cash transactions?
- Who reconciles the cash amounts withdrawn to the amount spent on cash purchases, and how is this done?
- How much cash do you typically keep on hand?
- Do you pay the same price per pound regardless of your payment method?
- How do you account for purchases made by check?
- Who signs checks?
- Are any purchases made from outside the United States?

Potential Abusive Situations

- Use of fictitious names
- Use of two different payees
- Falsified documents used in light-weighting scrap

Sellers of Scrap Metal

Major Issues

- Unreported Income
- Assignment of Income
- Unreasonable compensation and constructive dividends

Pre-Audit Steps

- Obtain documentation provided by purchasers, such as cash slips, shippers, invoices, and cancelled checks.
- Review the tax return to determine whether scrap income is reported separately from other income.
- Research the CBRS to determine whether any forms have been filed to report cash transactions in excess of \$10,000, such as Currency Transaction Reports.
- Request an interview and tour of the business.

Information Document Request

The following documents are typically requested in audits of scrap metal sellers:

- Weight tickets for scrap sales
- Shipping documents
- Invoices
- Receipts
- Cash slips
- Metal settlement reports
- Names and addresses of customers
- Internal documentation that records the amount and type of scrap metal generated by manufacturing operations
- Contracts or bids for large jobs

Interview Questions

- What internal controls do you have related to the quantity of scrap metal you generate?
- What records do you maintain related to the quantity of metal generated?
- Who monitors the amount of scrap metal that is generated?
- What is the process that takes place from the time the metal is generated until it is sold?
- Do you keep different types of scrap separate or combine them?
- What kinds of containers do you place the scrap in? How many containers do you use, and do you own them?
- How often are containers emptied?
- Who do you sell scrap metal to?
- What are your accounting procedures?
- Do you credit your purchases account when you sell metal, or is the amount included in gross receipts?
- Who records transactions in your books?
- How often are transactions recorded?
- Do you receive payments by cash, check, or both?
- When receiving checks, are they made out directly to your business?
- How are checks deposited?
- If payments are made in cash, who receives the cash and what happens to it?

- Why do you receive cash payments?
- If payment is made by cash, is that a decision made by you or the other party?
- What internal controls do you have in place to ensure that scrap metal is not diverted?

Other Common Industry Issues

The following issues are commonly found in audits of the scrap metal industry.

- Excise Tax.
- Inventory and Section 263A issues.
- Special rules for long-term contracts – income must be determined using the percentage of completion method.
- Traffic tickets and fines cannot be deducted as a business expense.
- International Issues –If metal is transported between countries, the examiner may be able to obtain customs forms.

TAXICABS

Primary Audit Issues

Although taxicabs commonly accept credit cards, it is still a cash intensive business. As with other cash intensive business, there is a high risk of abuse. Common issues during audits of these businesses include paying expenses with cash prior to depositing the money, maintaining inadequate records, unreported tips, and improperly classifying workers as independent contractors.

Determining tip income

If you classify your workers as employees, they should be reporting the tips they earn to you at least once each month. The examiner will request monthly summaries of the tips reported to you by each driver.

Examiners generally use either the Tip per Product Method, or the McQuatters formula to estimate the amount of tips that were received.

If you have credit card receipts exceeding 5%, the McQuatters formula can be used to calculate any unreported tip income. This formula uses gross receipts and credit card settlement transactions that contain a tip to calculate the overall amount of tips that should have been reported by employees. Generally, the higher the percentage of credit card transactions, the more reliable this formula is.

If you had a low percentage of credit card receipts, the examiner may use a Tip per Product Method. This method uses more subjective evidence, such as observation, oral testimony, and published information to estimate what the tip per transaction is, regardless of the dollar amount of the transaction.

The examiner may use a hybrid method. For example, if the trip sheets show that longer rides tend to be paid by credit card, and shorter rides tend to be paid by cash, the examiner may set a dollar cut-off for using the McQuatters formula versus the Tip per Product Method. The examiner may also interview your drivers, dispatchers, and other workers to gather evidence to support the mathematical computations.

Worker Classification

Taxicab drivers treated as independent contractors for tax purposes may actually be employees. The examiner will use a multi-factor test to determine the proper classification. The overriding consideration in this test is the amount of control that you have the right to exercise over the worker.

Audit Techniques

In addition to bank statement analysis, the examiner will use financial data that you file with local authorities or organizations to verify your income. They will also reconcile this data with your waybills.

In addition to fare income, a prevalent source of unreported income is lease income. The examiner will verify the number of lease drivers and the amount of lease income with income statements you file with permitting agencies. They will also check insurance records and perform a bank statement analysis. You will be expected to explain any discrepancies.

Initial Interview and Information Document Request

The following books and records are likely to be requested:

- Waybills
- Bank statements
- Financial statements filed with regulatory agencies
- Expense receipts and invoices
- Insurance settlements
- Purchase, sale, and loan agreements
- Lease driver agreements
- Forms 1099 issues to workers
- Number of taxicabs you own and accident history
- Franchise fee information

Examining tax returns

The following techniques will be used when reviewing your return and records:

- Reconcile waybills with any financial statements filed with third parties.
- Compare filed financial statements to the figures on the tax return.
- Check with the local Department of Motor Vehicles for the number of taxicabs owned and history of accidents.

- Perform bank deposit analysis to investigate the source of deposits.
- Use taxi formulas to estimate unreported income.
- Use receipts to substantiate major expenses.
- Look for unreported lease driver income.