Chapter 8: Schedule C Audit Issues

Corrections were made to this workbook through January of 2011. No subsequent modifications were made.

In order to secure additional funding from Congress, the IRS is under scrutiny to increase the percentage of tax returns being examined. It has made progress over the past few years, even though the hiring of new agents has barely kept up with the losses of manpower due to retirements. The IRS increased the number of correspondence examinations and also made an effort to increase the direct examination time of its revenue agents. The IRS wants to decrease the time from initial contact to case closure as well as decrease the time spent in each examination.

Revenue agents are told in group meetings to use the "80/20 rule," a theory that states that 80% of the potential errors are most likely found in the first 20% of time spent on the examination. Agents are instructed to find the major issues and close the examination, rather than analyze every item for a true (correct) amount of tax.

There is less time and resources allocated to training, and new revenue agents are integrated into the audit stream more quickly after their initial hire date. New hires have less access to experienced on-the-job instructors because most instructors themselves have a relatively short work history with the IRS. The IRS utilizes more computer-based training and less face-to-face training than was provided in the past. New revenue agents utilize the **Internal Revenue Manual (IRM)** and **audit technique guides (ATG)** to prepare themselves for audits. Both of these resources are available on the IRS website for anyone interested in learning more about IRS procedures and requirements.

Note. A list of ATGs available from the IRS as of September 2010 is available in the Reference Material section of this workbook.

Revenue agents rely on the ATGs for guidance when preparing for an audit. Tax practitioners can also use them to anticipate questions a revenue agent will ask during an upcoming examination.

The IRS, through tax-gap studies, determined that a larger portion of the tax gap is attributable to underreported or unreported income than to the impact of disallowed expenses. The largest single portion of the tax gap is associated with sole proprietorships. Consequently, the IRS will allocate more resources and instruct more revenue agents to spend time on Schedule C issues.

The two ATGs primarily used as references for this chapter are the retail industry ATG, revised in February 2009, and the cash intensive businesses ATG, revised in April 2010.

The objectives of these ATGs are to:

1. Have agents understand the business model of the taxpayer;
2. Find variable metrics that influence the flow of goods, cash flow, and revenues; and
3. Provide a path to directly or indirectly compute the business income and cash flow and compare it to the income reported on the return.

This chapter explains the retail industry and cash intensive businesses ATGs and analyzes five tools used to implement these audit approaches:

1. The bank deposit method
2. The indirect source and application of cash flow (cash T method)
3. Net worth method
4. Percentage markup method
5. Unit and volume method

This chapter also discusses specific tactics that IRS revenue agents employ in audits of e-commerce, gasoline stations, direct sellers, the food and beverage industry (restaurants, taverns, and grocery stores), beauty salons, and car washes.

GENERAL ISSUES IN RETAIL INDUSTRY

The revenue agent is trained to obtain a flow of receipts through the business. The IRM directs the agent to first evaluate internal controls as a means to understand the taxpayer's business model. If internal controls are strong, the revenue agent might place more reliance on the taxpayer's books and records. If internal controls are weak or subject to override, the revenue agent conducts more detailed testing to ensure the accuracy of the taxpayer's records or abandons testing altogether.

Example 1. During the initial interview, revenue agent Dwight asks taxpayer Bonnie to describe a transaction from the initial sale to the final recording in her books and records. Dwight either prepares a flowchart that shows all the steps from beginning to end, or he prepares a work paper describing the same steps in narrative form.

During the interview, Bonnie tells Dwight that there is one employee who prepares the customer receipt at the time of the sale. There is another employee who reconciles the cash register at the end of the day. There is a third employee who makes the physical bank deposit, and there is a fourth employee who records the deposit in the general ledger.

Because of the separation of duties, Dwight concludes that Bonnie's internal controls are strong. He will rely on these controls once he subjects them to testing. This may affect the scope and time of the engagement and allow him to focus on other issues.

Example 2. Revenue agent Dean conducts an initial interview with a taxpayer, Clyde. During the initial interview, he determines that Clyde and his wife are the only employees of the business. They receive all the cash, reconcile the cash register, make the physical bank deposit, and record the deposits in the general ledger. Dean concludes that the internal controls in this business are weak. He believes that the possibility of income not being reported is much more likely because the controls, if any, can be circumvented by the taxpayer and his wife. Dean must do additional substantive work to verify the accuracy of the taxpayer's records and determine that the substance of those records is complete.

The ATG refers to this assessment as "control risk." This is the risk that an error could occur and may not be found by the business's policies or procedures.

GENERAL ISSUES IN CASH INTENSIVE BUSINESSES

INTRODUCTION

In April 2010, the IRS issued a new ATG for cash intensive businesses. In this ATG, the IRS expresses its intention to treat issues and taxpayers consistently. The ATG is intended to be used by revenue agents for various types of businesses. It mentions general rules and advice which can be applied for all cash businesses. It also contains chapters dealing with specific industries, such as bail bonds, beauty shops, car washes, coin-operated amusements, convenience stores, and scrap metal. The IRS is in the process of developing additional chapters for check-cashing locations and laundromats. The ATG states that there are four main ways to misappropriate cash from a business:

1. It can be skimmed from receipts (pocketed before it is recorded). This is not discovered by auditing the books because the transaction is never recorded.
2. It can be stolen after it is recorded (removed from the cash register or stolen from inventory).
3. A fraudulent disbursement can be created (a payment made to a fictitious vendor).
4. A bribe, kickback, or rebate is offered or received in exchange for business.

The ATG identifies certain indicators of unreported income on a business owner's tax return:

- A consistent pattern of losses or low-profit percentages that seem insufficient to sustain the business
- A lifestyle or cost of living that is not supported by the income shown on the return
- A business that continues to operate despite recurring annual losses, with no apparent effort to correct the situation
- An indirect method of determining cash flow, or the cash T method, shows a cash-flow understatement
- Bank balances and investments of the owner increase despite reporting a loss on the tax return
- An increase in accumulated assets even though losses are reported on the return
- A decreased (or unchanged) debt balance despite reported losses
- A large difference between the taxpayer's gross-profit margin and that of the industry
- Unusually low annual sales for the type of business

The ATG advises revenue agents to be creative and flexible in the examination process and to treat each business as an individual case. The ATG also advises the revenue agent to conduct a financial status analysis (including a **required minimum income probe**) for both the business and personal financial activities of the owner.

If a potential understatement of income exists, the taxpayer is always asked to provide a reason for the potential discrepancy. An indirect method (discussed later in the chapter) can be used to determine the amount of any income adjustment. The examination of income is a mandatory audit issue with few exceptions. However, the depth of the examination of income depends upon the facts and circumstances of the audit. The revenue agent must consider tax return information; reliability of the taxpayer's books and records; the results of the minimum income probes; and the analysis of any large, unusual, or questionable items.

> **Note.** The examples throughout this chapter are simplified for ease of explanation. In these examples, there are likely other factors which could affect the amount of the income adjustment proposed. Some examples indicate that the revenue agent may contact third parties to verify items on a tax return or to form the basis for a potential income adjustment. Practitioners should carefully review all of the revenue agent's computations to ensure their completeness and factual accuracy.

Under IRC §7602, the IRS has very strict third-party contact rules which must be followed by the revenue agents to prevent unauthorized disclosure of tax return information to outside parties.[1] The revenue agent is instructed to ask the taxpayer first for any information needed and to contact third parties only if the taxpayer is unable or unwilling to provide the requested information. The information requested of a third party should be relevant and necessary to resolve the issue.

Revenue agents are instructed to respect the taxpayer's right to representation. The taxpayer is not required to submit to an interview without a summons; however, agents must talk to a person knowledgeable about the business's operations. A summons of the taxpayer is not used unless the taxpayer has already refused a request for an interview. The agent's respect of the taxpayer's right to representation is usually shown by not interrogating the taxpayer when the agent is aware that the taxpayer is represented and the authorized representative is not present.[2] Written information document requests (IDRs) usually govern the communications process, saving countless hours of "he said, she said" arguments and avoiding contextual statements or terms having a specific meaning in the tax literature.

The following is the normal sequence of events in the audit process for the revenue agent:

1. Precontact analysis
2. Initial telephone and/or letter contact with the taxpayer
3. Scheduling the initial interview
4. Requesting the initial books and records; usually on Form 4564, *Information Document Request*
5. Initial interview
6. Touring the business
7. Examination of books and records
8. Discussion of any issues with taxpayer
9. Additional records analysis if necessary
10. Closing conference
11. Securing agreement and payment from the taxpayer of any balance due
12. Closure of case to group manager

Note. Additional information can be found in Pub. 556, *Examination of Returns, Appeal Rights, and Claims for Refund.*

1. IRC §7602(c).
2. IRC §7521(b)(2).

PRECONTACT ANALYSIS

In the precontact analysis phase of an examination, the revenue agent reviews the tax return to identify any potential issues and the information that is needed to complete the examination. Some of the items shown in the cash intensive businesses ATG are as follows:

1. **Page 1 and 2 of Form 1040.** Is the taxpayer's address in an area that is not supported by the reported income? Is the taxpayer's occupation a position that could have indirect sources of additional income? Does the taxpayer's reported income support the family size shown on the tax return?
2. **Schedule A, *Itemized Deductions.*** Do the real estate taxes suggest that other property is owned by the taxpayer? Does this deduction show additional properties not commensurate with reported income? Does interest expense indicate indebtedness not commensurate with reported income? Are there miscellaneous deductions such as large gambling losses?
3. **Schedule B, *Interest and Dividend Income.*** Is the interest and dividend income consistent with reported income?
4. **Schedule D, *Capital Gains and Losses.*** The examiner notes the various sources and applications of funds.
5. **Schedule C or F.** The revenue agent notes the type of business; accounting method; gross-profit percentage; net income; interest and depreciation expenses; and any other large, unusual, or questionable items.
6. **ATGs.** The appropriate industry ATGs are reviewed.

The agent attempts to understand the taxpayer's business model. This analysis helps the agent tailor the initial interview questions applicable to the taxpayer's activities. The agent generally develops a forecasted cash T analysis in the precontact analysis stage to gain insight into the taxpayer's finances. This analysis is developed further as more information is obtained from the taxpayer and from the taxpayer's books and records.

INTERNAL AND EXTERNAL SOURCES OF DATA

There are various internal sources that the revenue agent uses to assist with the precontact analysis. In addition to the tax return, these sources include the following:

1. **Charge-Out Sheet.** This document usually describes prior audit activity.
2. **Information Return Documents.** These documents are normally summarized on an information returns program (IRP) document. The IRP lists various Forms W-2, Forms 1099, and other documents on file with the IRS for the taxpayer and for the taxpayer's spouse. If the taxpayer has a schedule C with an employer identification number (EIN), the agent will normally request IRP information for both the SSN and EIN.
3. **Accurint.** This report discloses various facts about the taxpayer, including known addresses, known businesses, some assets owned by the taxpayer, and potential third-party court documents.

> **Note.** Accurint is a research tool available to government, law enforcement, and commercial customers. It searches numerous databases to report information on the party being investigated.

4. **Currency and Banking Retrieval System.** This report discloses any currency transaction report filed on or by the taxpayer and any Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business,* filed on or by the taxpayer. It includes the dates and amounts of these cash transactions.
5. **Transcript of the Taxpayer's Account.** This is usually obtained by the agent for the current year and any other open years under the statute of limitations. The revenue agent may also obtain a document which shows the transcribed details of the prior and subsequent year tax return in order to prepare a comparative analysis.

6. **Third-Party Public Records Contacts.** These contacts are not subject to the third-party contact rules of IRC §7602(c). This information is available to the general public and includes contacts made with postal officials to obtain a taxpayer's current address, contacts made with a county clerk to obtain lien information, contacts made to obtain publicly-available court records, and contacts made to obtain publicly-available business information such as corporate registration or charter information. In some states, motor vehicle information is available to the general public and may be obtained by the agent.

7. **External Sources.** These include the Bureau of Labor Statistics, Social Security Administration, OSHA, Department of Social Services, Department of Agriculture, Small Business Administration, Department of Transportation, Fictitious Name Register, and Better Business Bureau. All of these are agencies from which information may be obtained without contacting the taxpayer. In addition, court records may be checked for divorce, lien, probate, bankruptcy, property records, and mortgages. State information on permits, licenses, sales tax, and employment/unemployment data may also be requested. The agent may also consult a city directory and contact public utilities, suppliers, financial institutions, insurance providers, and other third parties under the rules of IRC §7602.

8. **Websites and Social Media.** Agents can make use of search engines to find websites with valuable information about the business and taxpayer that may be of benefit to the audit process. Company websites can be used to research main business activities, company locations, company owners and board members, e-commerce activities, and company history. Social media websites such as Facebook, Twitter, Blogger, and LinkedIn can provide information about both the taxpayer's standard of living as well as the business.

A revenue agent may perform varying degrees of comparative analyses and ratio analyses, depending on the type of business.

In addition to the areas already mentioned, the taxpayer and practitioner should also be prepared to provide the revenue agent with the following items of information. These are normally requested in the initial information document request:

1. **Package Audit.** The agent will routinely request copies of other types of tax returns required to be filed by the taxpayer. Examples include sales tax returns, excise returns, and payroll tax returns.

2. **Prior and Subsequent Years' Tax Returns.** The agent will inspect these returns and compare them to the return for the year being audited.

INITIAL INTERVIEW

An initial interview is very important to the revenue agent. Information gathered in the initial interview establishes the course of the examination. According to the retail industry ATG:

> *. . . the primary purpose of the interview is to secure, by conversation with the taxpayer, sufficient facts which will present the overall financial picture, an understanding of the operations, and an overview of the record keeping practices. This is the examiner's chance to learn exactly how the business works and how cash is handled.*[3]

The interview may be the only opportunity for the revenue agent to speak with the taxpayer. Therefore, it is important for the agent to gather as much information as possible during this interview. The revenue agent looks for information not shown on the tax return that relates to business operations, the amount of cash on hand, and personal expenditures.

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3. IRS Retail Industry ATG, Training Document 10246-001 (Feb. 2009), p. 2-1.

It is not unusual for the initial interview of a taxpayer with a cash intensive business to last for two hours or longer. The revenue agent is trained to secure facts which:

- Explain the taxpayer's overall financial picture,
- Provide an understanding of the operations, and
- Provide an overview of the types of records maintained.

The agent also tries to determine the level of **internal controls** in the business. If the recordkeeping system is not thorough or complete, the oral testimony of the taxpayer may be the only evidence provided. The agent asks the taxpayer to explain every step from the time the cash or other income is received until it is deposited or spent. The agent may ask the taxpayer to repeat those steps for other types of gross receipts. The agent may prepare a flowchart and may ask the taxpayer if the flowchart is correct. The agent should also ask about cash that is used to pay the expenses of the business.

Another important component of the initial interview for the agent is to **determine the amount of cash on hand.** The revenue agent explains that cash includes pocket money, cash in a safe, or cash held in other locations. The cash on hand amounts at the beginning and end of the year are important facts in any subsequent indirect method used by the agent. They may either help explain a potential understatement of income, or may cause a potential understatement of income.

If the taxpayer is unsure of how to respond to these questions, the agent may try to narrow the response by starting with an estimate such as "over or under $10,000" and then narrowing that range until the taxpayer agrees to a general amount. The revenue agent wants the taxpayer to commit to an accurate dollar amount of cash on hand and commit to any change between the beginning and ending balances. The agent includes any statements made by the taxpayer in their work papers.

The agent asks the taxpayer about the **history of the business.** This helps the agent understand why certain expenses may be normal for the taxpayer's business and why an item may be large, unusual, or questionable. The agent may ask about:

- Other businesses that may be owned by the taxpayer (either presently or in the past),
- Bank accounts of the taxpayer (both business and personal),
- Investments and loan activity, and
- Any nontaxable income that is known to the taxpayer.

All this information assists the revenue agent in determining the overall financial position of the taxpayer. This information may help explain discrepancies found if the agent uses an indirect method. Obtaining a definitive statement from taxpayers during the initial interview makes it difficult for them to modify their response after an income adjustment is proposed.

> **Example 3.** Revenue agent Dwight has nearly completed his examination. An indirect method led him to determine that there is a potential understatement of income of nearly $100,000. He conducted a thorough initial interview, and Bonnie stated in the interview that there were no nontaxable sources of income and a constant amount of cash on hand throughout the year. When Dwight questions her about the potential understatement and explains his indirect method computations to her, Bonnie loses credibility if she replies, "I just remembered that I received a large inheritance from a deceased relative" or "I had $100,000 stuffed under my mattress, and I used it to fund my activities during the year."

To determine the overall picture of the taxpayer's business, revenue agents ask initial interview questions such as:

- How long has the taxpayer been in business?
- Who are the principal customers of the business?
- What are the principal products sold by the business?
- Are there any other sources of income?
- Does the taxpayer use the cash or accrual method of accounting?
- How does the taxpayer set prices?
- What is the markup percentage for each major product sold?
- How often does the taxpayer take an inventory?
- Does the taxpayer deposit all receipts?
- Who makes the bank deposits?
- How does the taxpayer handle personal withdrawals?
- How did the taxpayer arrive at the figures on the tax return?
- Is the taxpayer aware of any errors on the tax return?

Taxpayers are usually more responsive during the initial interview than later in the audit. Their answers are less biased because no issues are at stake. The agent attempts to use the taxpayer's vocabulary whenever possible and is flexible in using any outline previously prepared. The agent controls the interview, and documents the statements of the taxpayer. Agents are discouraged from taking verbatim notes in the presence of the taxpayer.

IRC §7605 and the related regulations state that the IRS determines the time and place of an examination; however, it is also stated that IRS employees will attempt to schedule a time and place that is reasonable given the circumstances.

IRC §7521 allows a representative with a valid power of attorney (Form 2848) to represent the taxpayer during an examination. When representation is utilized, the agent meets and deals in good faith with that representative; however, it is still likely that the taxpayer is the best person to answer the questions during the initial interview. Therefore, the agent requests that the representative ask the taxpayer to be present. The taxpayer's presence is not required unless there is an administrative summons. If it appears that a representative is shielding the taxpayer from the agent, the agent may bypass the representative and deal directly with the taxpayer according to the guidelines in the IRM.

PERSONAL EXPENDITURES

Many retail business owners divert inventory for personal purposes, especially in restaurants and grocery stores. The revenue agent must determine whether personal-use amounts are properly accounted for.

> **Example 4.** In the initial interview of a restaurant owner, revenue agent Dean asks Rachel if she, her family, and/or employees eat meals at the restaurant at a discounted price or at no charge. Rachel admits that this occurs, and that the amount of the food consumed is subtracted from the cost of goods sold. Dean needs to determine whether the amount is reasonable.

> **Example 5.** In the initial interview with Joe, a grocery store owner, revenue agent Dwight asks Joe whether any of the grocery items are consumed by Joe and his family. Joe replies that this does not happen. Dwight may do some additional substantive testing to see whether Joe has other out-of-pocket expenses to support his assertion, such as canceled checks and credit card receipts evidencing frequent eating out or special diet requirements.

BOOKS AND RECORDS

Some taxpayers may have very detailed books and records while others may have no books and records. The complexity and completeness of these records, if present, can affect the scope of the examination.

> **Example 6.** Revenue agent Dwight finds that the taxpayer's books and records include various journals and ledgers. Dwight's previously-prepared flowchart indicates that these records, in conjunction with the strong internal controls of the taxpayer, provide a high degree of reliability. Therefore, Dwight might not conduct additional testing of the taxpayer.

> **Example 7.** Revenue agent Dean finds that the taxpayer's books and records consist only of a check register. In order for Dean to conduct a thorough examination per the ATG, he must, at a minimum, analyze the bank statements of the taxpayer to determine if any transactions were omitted.

Indirect Methods

IRM 4.10.4.6 refers to indirect methods as "financial status audit techniques." IRC §7602(e) states that:

> *. . . the Secretary shall not use financial status or economic reality examination techniques to determine the existence of unreported income of any taxpayer unless the Secretary has a reasonable indication that there is a likelihood of such unreported income.*

A cash business, in and of itself, does not give the revenue agent the needed reasonable indication to use indirect methods. However, incomplete books and records and/or weak internal controls can prompt the agent to seek permission from his supervisor to utilize indirect methods to determine whether there may be unreported income in accordance with IRC §7602(e).

There are five **indirect methods** that an examiner may use when the taxpayer's records are not available or are inadequate:

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1. Bank deposit analysis
2. Application of funds method and cash T methods/source
3. Net worth method
4. Percentage markup method
5. Unit and volume method

If a potential income adjustment using one of the above methods exists, the revenue agent uses a second method to support the adjustment. If the taxpayer's books and records are nonexistent or unreliable, an agent's adjustment computations will likely be supported by the courts if they are reasonable. The burden of proof is on the IRS, and they are generally successful when the taxpayer's records are lacking. In court, the taxpayer must refute items in IRS computations.

Bank Deposit Analysis. Bank deposit analysis assumes that the business owner deposits all business income into a bank account. This type of reconciliation is sometimes known as a "proof of cash" analysis. It attempts to show what happens to the taxpayer's funds. If a taxpayer receives money, there are two possibilities: it was either deposited or spent. In a bank deposit analysis, the agent analyzes the deposits and reconciles nontaxable deposit sources. The agent then compares the total taxable deposit with the reported gross income.

This method is recommended for a business that deposits receipts regularly and pays most expenses by check. The cash receipts formula is as follows:

	Total reconciled bank deposits
−	Nontaxable receipts deposited
	Net deposits resulting from taxable receipts
+	Business expenses paid by cash
+	Capital items paid by cash
+	Personal living expenses paid by cash
+	Cash accumulated during the year from receipts
−	Nontaxable income used for the above additions
+	The difference between the ending and beginning accounts receivable balances
−	The difference between the ending and beginning accounts payable balances
	Gross receipts as corrected

The corrected gross receipts amount is compared to the gross receipts on the return for the amount of the potential proposed audit adjustment.

The amount of bank deposits during the year is adjusted up by any receipts deposited in transit the subsequent year and adjusted down by any prior year's receipts deposited in the current year to arrive at reconciled bank deposits.

Nontaxable receipts could include loan proceeds, checks made out to cash and redeposited, NSF checks redeposited, transfers between accounts, proceeds from the sale of investments that are a return of basis, and any deposits from a nontaxable source such as a gift or inheritance.

Determining the amount of business expenses paid by cash also involves some computations. The total business expenses on the return are used as a starting point. Noncash business expenses (such as depreciation or amortization) are subtracted. Total business checks are subtracted from this total, resulting in the total business expenses paid by cash.

The amount of total business checks is computed as follows:

	Bank account balance at the beginning of the year
+	Deposits during the year
−	Account balance at the end of the year
+	Checks written this year that cleared in the subsequent year
−	Checks written in the prior year that cleared this year
	Total checks written this year
−	Nonbusiness checks
	Total business checks

Nonbusiness checks include checks written to cash for personal expenses, checks written for a transfer between accounts, and any personal or capital expenditures paid by check.

There are various items that need to be taken into account when performing a bank deposit analysis. The retail industry ATG mentions the following seven points that must be considered:

1. Cash payouts are not deposited, but the money used to make the cash purchases originated from sales. This is cash that would not be deposited into a bank account and must be added back to the bank deposit analysis.

2. Credit card payments from credit card companies for sales include deposits of employee tips plus the sales taxes plus the sale. Only the portion representing the sale is included in gross income.

3. In a restaurant, business cash payment of employee credit card tips is money that is not deposited, but originated from sales. Again, this cash must be added back to the bank deposit analysis.

4. Sales tax collected from customers for cash sales is money deposited that is not a source of income.

Note. In many states, the sales tax for restaurants and bars is higher than the sales tax for other retail business.

5. Cash collected from vending machines is cash that must be deposited and included in gross receipts. If significant coin and currency deposits are not found on the deposit slips, the examiner may need to determine the amount of income from this source and add it to the bank deposit analysis.

6. Loans from shareholders are a nontaxable source of cash. Proof of payment is necessary to establish facts.

7. Transfers between bank accounts are nontaxable.

Application of Funds Method and Cash T Method. In the application of funds method, or cash T method, all sources of cash are compared to the known applications of cash. If the total of applications exceeds the total sources of cash, the examiner most likely assumes that there is an understatement of taxable income. This method is recommended by IRM 4.10.4.6 when the taxpayer's deductions appear out of proportion to the income reported, if all cash does not flow through a bank account, and/or the taxpayer pays many business expenses by cash. The revenue agent most likely performed a preliminary informal cash T analysis on a tax return before the initial interview since most of the amounts come from the tax return as reported. If a discrepancy exists, it could either be due to an underreporting of income or an overstatement of expenses. As the examination progresses, the cash T amount is updated as amounts are verified.

Examples of **potential sources of funds** include the following:

- Wages
- Interest income
- Dividend income
- Tax refunds
- Alimony received
- Schedule C gross receipts
- Schedule D gross proceeds
- Sales of business property from Form 4797
- IRA and pension distributions
- Rental income
- Schedule F receipts
- Unemployment compensation
- Social security benefits
- Cash distributions from S corporations, partnerships, or fiduciaries
- Sale of personal residence
- Sale of personal property
- Advance EIC
- Child support received
- Beginning cash on hand
- Beginning cash in bank
- Credit card balances at end of year
- Loans
- Nontaxable income
- Accrual basis decrease in accounts receivable
- Accrual basis increase in accounts payable

Examples of various **potential applications of funds** include the following:

- W-2 withholdings
- Investment interest paid
- Schedule C expenses net of depreciation
- Schedule C cost of goods sold — purchases, labor, materials and supplies, etc.
- Asset and investment purchases
- Contributions to IRAs, annuities, or pensions
- Contributions to HSAs
- Penalties for early withdrawal
- Rental expenses net of depreciation
- Schedule F expenses net of depreciation
- Contributions of capital to S corporations or partnerships
- Expenses of sale of assets
- Current year improvement costs
- Insurance policy premiums
- Ending cash on hand
- Ending cash in bank
- Credit card balances at beginning of year
- Loan repayments
- Personal capital acquisitions
- Personal living expenses
- Accrual basis increase in accounts receivable
- Accrual basis decrease in accounts payable

As mentioned earlier, cash on hand is an important factor in the computations. If the taxpayer states in the initial interview that the cash on hand balance was the same at the beginning and end of the year, then the net effect is zero. The revenue agent may ask if cash on hand ever exceeds a certain amount (for instance, $1,000) at any time during the year (or at the current time). If the taxpayer states that the amount of cash on hand is constant, then it is not a factor in the computations. The taxpayer may overstate the cash on hand at the end of the year thinking that it will be helpful to the outcome. However, that tactic actually has the opposite effect. Doing that increases the potential for understatement of income. It becomes difficult for the taxpayer, when faced with a potential understatement, to change his story and state that there was an additional source of beginning cash on hand.

Example 8. Revenue agent Dwight, in the examination of a towing company, was told by Tommie in the initial interview that a safe at the business location was broken into, and that cash in the amount of $50,000 was stolen during the taxable year. Tommie believes that this gives rise to a casualty loss. However, he was unable to show that the amounts in the safe were ever reported as income. A corresponding income adjustment is proposed by Dwight.

Both the bank deposit analysis and the cash T method require an entry for personal living expenses. Any personal living expenses found to be deducted on Schedule C are removed from the computations as the examination progresses.

IRM 4.10.4.6 states that the determination of personal living expenses is an examination technique that should only be used after the decision to use an indirect method has been made. Many years ago, the IRS performed "economic reality audits," in which the IRS attempted to determine the standard of living of the taxpayer (including their personal living expenses). If the taxpayer's standard of living was higher than the income reported on the tax return, and no known additional sources were found, the IRS assumed that unreported income existed and it proposed an adjustment. At that time, the IRS sent a Form 4822, *Statement of Annual Estimated Personal and Family Expenses*, and asked the taxpayer to complete it before the initial interview. As a result of complaints from taxpayers about the intrusiveness of this method when no real indications of unreported income were known, the IRS abandoned this technique. The IRM states that Form 4822 is used as a guide by the revenue agent, and that it is inappropriate for the taxpayer to complete the form independently.

Form **4822** (Rev. 6-83)

Department of the Treasury - Internal Revenue Service

STATEMENT OF ANNUAL ESTIMATED PERSONAL AND FAMILY EXPENSES

TAXPAYER'S NAME AND ADDRESS	TAX YEAR ENDED

		ITEM	BY CASH	BY CHECK	TOTAL	REMARKS
1. PERSONAL EXPENSES		Groceries and outside meals				
		Clothing				
		Laundry and dry cleaning				
		Barber, beauty shop, and cosmetics				
		Education *(tuition, room, board, books, etc.)*				
		Recreation, entertainment, vacations				
		Dues *(clubs, lodge, etc.)*				
		Gifts and allowances				
		Life and accident insurance				
		Federal taxes *(income, FICA, etc.)*				
2. HOUSEHOLD EXPENSES		Rent				
		Mortgage payments *(including interest)*				
		Utilities *(electricity, gas, telephone, water, etc.)*				
		Domestic help				
		Home insurance				
		Repairs and improvements				
		Child care				
3. AUTO EXPENSES		Gasoline, oil, grease, wash				
		Tires, batteries, repairs, tags				
		Insurance				
		Auto payments *(including interest)*				
		Lease of auto				
4. DEDUCTIBLE ITEMS		Contributions				
	Medical Expenses	Insurance				
		Drugs				
		Doctors, hospitals, etc.				
	Taxes	Real estate *(not included in 2. above)*				
		Personal property				
		Income *(State and local)*				
		Interest *(not included in 2. and 3. above)*				
	Mis-cella-neous	Alimony				
		Union dues				
5. PERSONAL ASSETS, ETC.		Stocks and bonds				
		Furniture, appliances, jewelry				
		Loans to others				
		Boat				
		TOTALS ▶				

Form **4822** (Rev. 6-83)

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The IRS may use Bureau of Labor Statistics data to determine the costs to maintain a household. This data is found at **www.bls.gov/cex/csregion.html** under "Inflation and Consumer Spending." There are tables for various years and regions of the United States. IRM 4.10.4.6 states that these amounts of average personal living expenses cannot be used as a substitute for the taxpayer's books and records or other information. It also indicates that these averages should only be used when **all three** of the following conditions are met:

1. The taxpayer is in a business or income-producing activity other than as an employee.
2. The taxpayer is a nonfiler.
3. The taxpayer is uncooperative with the examiner or does not meet with the examiner.

Net Worth Method. In the net worth method, a taxpayer's total assets and total liabilities are determined at the beginning and end of the year. The difference between the total assets and total liabilities is the taxpayer's net worth. If there is an increase in net worth during the year, it is assumed to be taxable income unless the taxpayer provides proof of nontaxable sources. This method is often used when the income source is illegal or if an entire business entity is unreported.

Percentage Markup Method. The percentage markup method involves the verification of cost of goods sold and the determination of a standard markup percentage that is considered typical for the business or industry. These percentages are primarily used to determine gross receipts but can also be used to determine cost of goods sold, gross profit, or net profit.

These percentages can be determined by using the Bureau of Labor Statistics, annual statement studies provided by the Risk Management Association, the industry and financial ratios published by Leo Troy, industry publications, or the standard industrial classification (SIC) code or the North American Industry Classification System (NAICS) analysis. If the taxpayer's actual markup percentage is known, it should be used. That markup percentage is applied to determine the potential amount of gross receipts. This method is most often used when the taxpayer's cost of goods sold or merchandise purchased is from one or two sources. The IRM recommends this method:

- When cash outlays cannot be determined or when cash is not deposited, and
- When inventories are a principal income-producing factor and the taxpayer's records are nonexistent or are unreliable.

It is most effective for liquor stores, taverns, gas stations, restaurants, and jewelry stores. The IRM advises agents to use the taxpayer's records and oral testimony as the best sources of information.

IRM 4.10.4.6.5.1 refers revenue agents to case law in which the markup method was used successfully. In *Barragan,*[4] the IRS used a supplier's delivery records for a gas station and retail prices from an independent market survey. In *Stafford,*[5] another gas station's gross receipts were determined using Bureau of Labor Statistics data. In *Webb,*[6] the method was used for the sales of liquor. In *Yorkville Live Poultry Co.*,[7] the court approved a net-income computation based on 4% of net sales when no books were available. This method was also used to determine estimated tip income at restaurants.

Example 9. Revenue agent Dean examines a used car dealership. He determined from his research and from his initial interview that the markup percentage for the types of vehicles sold by the taxpayer is 20%. He verified that the taxpayer's cost of the vehicles purchased is $100,000. Dean calculates the total markup to be $20,000 ($100,000 × .20).

Dean adds the markup ($20,000) to the cost of vehicles purchased ($100,000) and proposes that the taxpayer's gross receipts are $120,000.

4. *Barragan v. Comm'r,* TC Memo 1993-92 (Mar. 17, 1993).
5. *Stafford v. Comm'r,* TC Memo 1992-637 (Nov. 2, 1992).
6. *Webb v. Comm'r,* 394 F.2d 366, 371-372 (5th Cir. 1968).
7. *Yorkville Live Poultry Co. v. Comm'r,* 18 BTA 47 (1929).

Example 10. Revenue agent Dwight examines a retail clothing outlet. During the initial interview, he was told by Vera that the clothing purchased is marked up by 40% prior to being placed on the racks. Dwight verifies that the total clothing purchased was $200,000. The total markup is determined to be $80,000 ($200,000 × .40). This is added to the cost of goods sold to arrive at total gross receipts of $280,000. That amount is compared to the amount shown on the tax return. If this amount is larger, an income adjustment is proposed.

Unit and Volume Method. The retail industry ATG recommends the use of the unit and volume method to determine a possible daily sales amount. For example, in a restaurant, the average number of customers in a day is multiplied by the average check per customer to arrive at a daily sales amount. This daily sales amount is multiplied by the number of days the restaurant is open per year to determine the annual sales.

This method can also be applied to a laundromat, theater, beauty salon, or sports arena. The IRM recommends that this method be considered when the examiner can determine the number of units and the average price per unit, and when only a few products are sold or materials are purchased. In addition to these calculations, the retail industry ATG recommends that other audit procedures be used, such as tracing gross receipts to bank deposits.

IRM 4.1.4.6.6.1 discusses four court cases in which the unit and volume method was approved by the courts. In *Salami*[8] and *Irby*,[9] cab drivers' gross income was determined using gas expenses claimed, price per gallon, miles per gallon, and occupancy rates. In *Maltese*,[10] the gross income of a pizza parlor was determined by using the number of pizza crusts per 100 pounds of flour multiplied by the average price per pizza. In *Stanoch*,[11] gross receipts for a tavern were determined using the amount of liquor per drink minus a percentage for spillage.

Example 11. Revenue agent Dean examines a coin-operated laundromat. He determines from the taxpayer's utility bills that 270,000 gallons of water (after spillage) were used by the entity for the year. He also determined that the average amount of water per washer load is 27 gallons. Therefore, there were 10,000 washer loads for the year. He multiplies this by the average price per washer of $3 to determine gross receipts of $30,000.

Revenue agent Dwight, who is assisting with the audit, determines that the average use of dryers by the customers is 75% of the wash loads. He multiplies the 7,500 dryer loads (75% of 10,000) by the $1.50 average dryer cost to determine gross receipts for dryers of $11,250.

Dean and Dwight also need to determine gross receipts from vending machines that sell detergent, as well as soda and snack machines at the site. If the entity offers dry cleaning services, this method can also be used if the number of customers or dry cleaned garments can be determined for an average day, week, or month.

If the revenue agent determines an understatement of income using any of these methods, he tries to discover specific items that may have gone unreported. Even if no specific items are found, the agent may still propose an income adjustment to the taxpayer's return.

MINIMUM INCOME PROBES

IRM Section 4.10.4.3.3 states that minimum income probes are conducted during every examination with few exceptions. If the minimum income probes show that all taxable income from known sources is reported, the examination may be limited. If the minimum income probes indicate the potential for unreported income, an indirect method may be needed to determine the potential amount of unreported income as explained earlier. Given that Schedule C is part of the Form 1040 series, which include personal or nonbusiness income and deductions, all business and personal bank accounts are included in the analysis by the agent.

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8. *Salami v. Comm'r*, TC Memo 1997-347 (July 29, 1997).

9. *Irby v. Comm'r*, TC Memo 1981-399 (July 30, 1981).

10. *Maltese v. Comm'r*, TC Memo 1988-322 (July 27, 1988).

11. *Stanoch v. Comm'r*, TC Memo 1959-132 (June 29, 1959).

The IRM states that the following audit techniques are used for a business return:

1. A financial status analysis to estimate whether reported income is sufficient to support the taxpayer's financial activities
2. An interview with the taxpayer to give the taxpayer the opportunity to explain how the business works, identify sources of nontaxable funds, and establish cash on hand
3. A tour of the business site to learn about the operations and internal controls, and to determine income sources
4. An evaluation of internal controls to determine high-risk issues and the examination's potential scope and depth
5. Reconciliation of the taxpayer's books and records to the return
6. An analysis of bank accounts to evaluate the accuracy of gross receipts reported on the return
7. An analysis of business ratios to identify issues. This may include a comparative analysis of multiple years' returns.

If all these steps are not followed, they must be documented in the case file and approved by the group manager.

The retail industry ATG discusses additional sources of receipts, such as vendor rebates and allowances (volume discounts, advertising allowances, cooperative advertising, defective merchandise, markdown participation, shelving or fixture allowances, and others), purchase credits and chargebacks, income from related activities, promotional allowances, prizes and trips, consignments, sales of accounts receivable, lottery sales, vending machines, and bartering.

The retail industry ATG also discusses income from gift certificates. The IRS takes the position that income from the sale of gift certificates is reported when received unless the taxpayer elects under Treas. Reg. §1.451-5 to defer it to the earliest of the time the income is earned under the all-events test or the income is recognized in the taxpayer's books or the last day of the second taxable year following the year of receipt. The retail industry ATG advises the examiner to look at the all-events test first. If all events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy, then the income should be reported. If the gift certificates have an expiration date or a fee for each time period unused, the test would be met at those times.

Caution. Tax practitioners must educate themselves on IRS audit techniques to help them make a determination as to whether their clients appear to be reporting all income. The IRS has recently held a CPA accountable for not making such a determination and **disbarred** him.[12]

12. IRS News Rel. IR-2010-82 (July 6, 2010).

SPECIFIC INDUSTRY ISSUES

E-COMMERCE

According to the U.S. Department of Commerce Census bureau, online retail sales increased by 243% from 2000 to 2004, rising from just over $28 billion to nearly $69 billion. The IRS instructs its examiners to determine whether the taxpayer has sales through the Internet and/or an Internet presence. The agent asks the taxpayer during the initial interview whether there is a website for the business, unless the agent already completed some preliminary work to determine how much the taxpayer relies on the Internet for business. The retail industry ATG directs the revenue agent to:

1. Ask the taxpayer during the initial contact whether the business has a website;
2. Check for a website using a search engine;
3. Look in the Yellow Pages to see whether a website is advertised;
4. Check a business card for an email address, a company domain name, and/or a website address; and
5. Look for deductions on the tax return for website development costs or larger than normal depreciation deductions for web servers, networking equipment, and payments to Internet access providers.

The retail industry ATG provides an interview questionnaire about e-commerce that agents may use in whole or in part. The questionnaire includes the following questions:

1. Does the taxpayer have an Internet presence?
2. Does the taxpayer conduct business transactions over the Internet? Does the taxpayer accept orders and/or payments over the Internet? What types of records are maintained for these transactions (electronic or paper)?
3. What products, services, or memberships may be purchased on the taxpayer's website or through the use of email?
4. When was the website opened for business? Did the business exist prior to the creation of the website? Is the business conducted over the Internet separate or distinct from the taxpayer's historic line of business?
5. What domain names were registered either by the taxpayer or on the taxpayer's behalf? What domain names does the taxpayer have control over? What is the date of registration and the name of the registrant?
6. How is the fee for Internet connection services determined?
7. How was the business's Internet website developed (i.e., outside consultant, internal staff, website design software)? The agent will ask for details regarding all consulting fees, employee salaries, design software, etc.
8. How many employees are engaged in the Internet-based business activity? The agent will ask for the job titles, compensation, and names of employees who are responsible for website design and website hosting.
9. How much has the taxpayer paid to outside vendors, including nonemployee compensation, for website development and website hosting?
10. What type of credit cards does the taxpayer's financial institution accommodate?
11. What is the name of the financial institution that clears the taxpayer's credit card receipts? Was an application or merchant services sign-up form completed for the credit card clearing services?
12. Does the taxpayer's ISP or the entity providing server space process credit card transactions?
13. Has the taxpayer used any other financial institutions in conjunction with the business's website?

14. Does the taxpayer's financial institution provide charge authorization, transaction capture, settlement, chargeback handling, reconciliation, reporting, or prepaid card issuance and acceptance?
15. What type of payment-processing software does the taxpayer use? The agent notes the vendor's name and address. If the taxpayer does not know the name of the software, the agent asks whether the ISP hosting the website is providing the software.
16. How are credit sales handled and how are they recorded in gross receipts?
17. How are noncredit sales handled and how are they recorded in gross receipts?
18. How is information for approved or authorized credit card purchases processed?
19. What is the sequence from order entry to shipment?
20. How are products shipped and which shippers are used?
21. Who are the taxpayer's major suppliers and vendors?
22. From what location are shipments made?
23. Does the taxpayer have any paid referral or advertising contracts with other Internet websites? If the answer is yes, the agent obtains copies of the contracts.
24. Does the taxpayer swap (barter) links, banner space, and server space with any other businesses?
25. Does the taxpayer have any foreign operations?
26. Does the taxpayer have direct or indirect control over any foreign corporations, foreign partnerships, foreign trusts, or any other foreign business enterprises?
27. Does the taxpayer have any direct or indirect control over foreign bank accounts or other offshore accounts?

The retail industry ATG also lists expenses that may be contained in other deductions that would tell the examiner that there is Internet activity. Typical expenses include the following:

- Website design costs
- Website maintenance costs
- Cable modem access
- Website consulting fees
- Network service fees
- Domain name registration fees
- Internet service provider fees
- Website hosting fees
- Domain name cost

There may be depreciation deductions for servers, computer software, routers, phone lines, website design costs, significant computer purchases, modems, telecommunication equipment, domain names, or switches.

The agent normally asks the taxpayer about the procedures used when a product sale is conducted on the taxpayer's website. If payments can be made online, the agent attempts to reconcile credit card, PayPal, and other electronic payments back to the books and records. The agent checks for advertising income for banner ads and pop-up ads and asks how this income is accounted for. In addition, agents use a percentage markup technique for the purchases and/or reconcile shipment costs with both cost of goods sold and income to see whether there is underreporting.

Example 12. Revenue agent Dwight, in his analysis of the records for Stephen's electronic business, determines that payment was made to ship 500 items through FedEx, USPS, and UPS. He examines the income records to see whether all 500 items are included as income. He then asks the taxpayer to account for any differences.

Other issues mentioned in the retail industry ATG alert agents to look for timing issues (whether an item should be depreciated or currently expensed). Timing issues include the following:

- Business start-up costs
- Acquisition of domain names and website development costs
- Acquisition of hardware and equipment
- Acquisition of intangibles
- Acquisition of software
- Lease expense
- Catalog costs
- Research and experimental expenditures and credit

GASOLINE SERVICE STATIONS

Service stations are still mainly cash businesses. However, there is a trend toward more gasoline being paid by credit card because customers prefer the time savings of paying at the pump. An increasingly higher percentage of profit is now coming from sales of convenience items, where the markup is higher.

The retail industry ATG provides an initial interview questionnaire for revenue agents to use. The following are examples of questions in the ATG:

1. What are the gasoline products' markups per grade? Was it the same in the prior year?
2. What is the merchandise product markup? Was it the same in the prior year?
3. Is there inventory on consignment (fuel, merchandise, etc.)?
4. What is the hourly rate for mechanics?
5. What is the daily gasoline sales volume? By type of gasoline? By season?
6. What is the daily merchandise sales volume? By season?
7. How often does the taxpayer receive a fuel or merchandise load?
8. Are credit card sales accepted? What percentage of credit card sales relates to gasoline?
9. What companies provide gasoline or other products?
10. What were the beginning and ending inventories for the year in question?
11. Has the station been remodeled? When? How long was the station closed for remodeling? Who paid for the remodel? Did the taxpayer receive any reimbursement for the remodel? Did the taxpayer receive financial reimbursements such as business-income replacement?
12. Name all of the suppliers for gasoline and other products that are offered for sale.
13. What percentage of gasoline sales is full service?
14. Does the taxpayer purchase blending products such as alcohol, naphtha, and transmix?

15. Does the taxpayer own delivery trucks? If yes, does the taxpayer supply fuel for the trucks? Who is the fuel bought from?
16. Does the taxpayer distribute products to anyone else?
17. Was the taxpayer required to file a Form 720, *Quarterly Federal Excise Return*, or Form 2290, *Heavy Highway Vehicle Use Tax Return*? Did the taxpayer file it?
18. Is all fuel purchased with federal excise tax included in the purchase price?
19. How many bulk storage tanks are there?
20. What is the capacity of the bulk storage tanks?
21. How many gallons are in inventory at yearend?
22. Is gasoline ever sold as diesel fuel?
23. How do customers use propane?
24. Are other items sold or services rendered at the location? Sites that have a beer and wine license sell much more merchandise than a site without a license.
25. Where is the station located? A good location site usually has a high volume of sales.
26. Are cars for sale at the location?
27. Are there any other service stations owned in whole or in part as an individual, partner, and/or shareholder?
28. What are the current selling prices? The agent notes variances between prices of gasoline at the taxpayer's station and other stations in the area.
29. How many pumps? What are the grades of product being sold and are there any other products such as diesel fuel, propane, kerosene, or blending products?
30. Have internal controls been addressed? Are the internal controls currently in place the same as those during the year under audit?

The revenue agent may visit the station prior to the start of the audit and place a copy of a map showing the station's location in the audit file. The agent observes and notes types of nongasoline activities.

If it appears that the taxpayer is **underreporting income,** the ATG directs the agent to consider issuing a summons to the oil company for records of its sales to the taxpayer. The unit and volume method discussed earlier may then be used to determine gross receipts from gasoline sales.

If the service station performs **automobile repairs,** the income sources consist of an hourly rate and parts charges. The revenue agent can use a combination of the unit and volume method and the percentage markup method to determine total service income.

Example 13. Revenue agent Dean examines a service station that has one service bay and one mechanic. He determines through his research that the station charges $40 per hour for six hours of work in an average day; totaling $240 of daily income. The service station pays the mechanic $20 per hour for an 8-hour work day, for total labor costs of $160 per day. Therefore, the daily net profit is $80 ($240 – $160).

The service bay is typically open five days per week except when a week includes a holiday. The $80 per day is multiplied by 250 days worked for a total gross profit of $20,000 for the year. For businesses with multiple service bays and/or multiple mechanics, this amount would be multiplied by the number of service bays and the number of mechanics at the station.

Revenue agent Dean also determines that the normal markup on parts sold is 50%. If the cost of the total parts sold per the taxpayer's records was $20,000, then the total parts income would be $30,000 (150% of $20,000).

The retail industry ATG lists various expenses to consider when examining gasoline service stations. These include the following:

1. The double deducting of rental expense or a rent rebate received from the oil company
2. Franchise fees and covenants not to compete which could be disguised goodwill
3. Prepayments of gasoline when the payments are placed in a savings account and eventually returned to the taxpayer (This may be shown as a gasoline reserve on the purchase invoice, and the revenue agent should determine the actual expenditure for just the gasoline.)
4. Rebates for increased purchases or other incentive programs
5. Shrinkage, leakage, theft, and personal use (Any large amount claimed should be substantiated, as industry experience shows that this amount is de minimis.)
6. Depreciation related to class lives of the retail station building, car wash buildings and associated land improvements, canopies, signs, tanks, pumps, and environmental cleanup

DIRECT SELLERS

Direct selling is a rapidly growing industry. The retail industry ATG estimates that U.S. sales by direct sellers were nearly $30 billion in 2003 with more than 55% of the American public having purchased goods or services through direct selling. The ATG also estimates that over 13 million people are involved in direct selling in the United States alone. Approximately 90% of those individuals operate their businesses part-time. The IRS estimates that direct sellers spend 44% of their time selling the product or service, 20% of their time on administration and paperwork, 15% of their time on recruiting or sponsoring others, 10% of their time on either training someone else or receiving training themselves, and the remainder on miscellaneous other duties.

There are two ways that a direct seller can earn income:

1. They can sell the product and earn a commission.
2. They can recruit new representatives and receive a percentage of the sales totals of these recruits.

Commission percentages vary by company. There is an extensive list of commission percentages in the ATG and a more complete listing of companies is maintained by the Direct Selling Association (DSA) in their membership directory. The direct seller receives an additional benefit in the form of a personal discount ranging from 20% to 50% on personal purchases of the products offered by the company. In addition, many direct sellers take products out of inventory for personal use. These costs must be removed from cost of goods sold.

> **Note.** De minimis discounts are not included in income.

Direct sellers normally receive a Form 1099-MISC from the company. Form 1099-MISC amounts are generally based on the retail sales of products when the direct seller earns a commission. There may be additional sales of items that are sold on a nonprofit basis (either a charitable purpose or as a reward for meeting a preset sales figure per customer). **Most taxpayers have the misconception that the amounts shown on Form 1099-MISC are the only income that is taxable.** In the ATG, revenue agents are advised to look for the following items, which are also income to the direct seller:

1. Commissions, bonuses, or percentages of income received as a result of sales from others
2. Prizes and awards received from the distributor, which are taxable under IRC §74
3. Products received as a result of meeting certain sales quotas
4. Gifts to help the direct seller make sales (The FMV of these gifts, which are considered payments, must be reported as income. Gifts given to the hostess or any other persons are not included in income.)

The retail industry ATG also lists various expenses for an examination of a direct sellers' return that may be an issue. Expense issues include the following:

1. Start-up expenses (The cost of exploring different direct selling opportunities, the cost of training before becoming a direct seller, any fees that must be paid to the company to become a direct seller, and expenses for starter kits are start-up expenditures under IRC §195 or included in inventory.)

2. Other inventory issues (In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor.)[13]

3. The treatment of products on hand kept by the direct seller as samples or demonstrators

According to the DSA, nearly 100% of direct sellers are classified for federal tax purposes as independent contractors. If they show a net profit, that profit is subject to SE tax. The more common issue raised by the IRS is whether the direct seller is truly attempting to make a profit or is conducting the activity as a hobby with no real chance of making a profit.

The Code limits deductions for an individual if the activity is not engaged in for profit.[14] The term "activity not engaged in for profit" is defined as any activity, other than one with respect to which deductions are allowable for the taxable year under IRC §§162 or 212.[15]

If an activity is not engaged in for profit, the taxpayer is allowed to deduct the amounts that would be allowable as deductions if the activity were engaged in for profit, but only to the extent of any remaining gross income.[16] In effect, any loss claimed would be disallowed. An activity is presumed to be engaged in for profit if the gross income derived from the activity exceeds the deductions attributable to the activity for three or more of five consecutive taxable years.[17] If this is the case, the IRS has the burden of proof to establish that the activity is not engaged in for profit. Otherwise, the burden of proof is on the taxpayer.

The regulations provide nine factors to be used in determining whether a taxpayer is conducting an activity with the intent of making a profit. No one factor is controlling and other factors may be considered. Some factors may be considered to be more important than others by either the IRS or the taxpayer. The mere fact that a preponderance of the nine factors indicate that there is (or is not) a profit objective is not conclusive. These nine factors are as follows.

1. The manner in which the taxpayer carries on the activity (Are the activities conducted in a business-like manner? Are there business records, formal budgets, profit projections, or break-even analyses prepared?)

2. The expertise of the taxpayer or his advisors (Did the taxpayer seek the advice of experts about the business activities? Did he attend events that he believed would provide the expertise for him to become profitable?)

3. The time and effort expended by the taxpayer (The quality of the time spent is more important than the amount of time spent on the activity. For example, if the taxpayer has other full-time employment, he could still meet this factor depending upon how his time was spent.)

4. The expectation that assets would appreciate in value

5. The taxpayer's success in other activities (If the taxpayer has engaged in similar activities in the past and has converted them from unprofitability to profitability, that may indicate that the present activity is engaged in for profit, even though it may not currently be profitable.)

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13. IRC §471.

14. IRC §183(a).

15. IRC §183(c).

16. IRC §183(b).

17. IRC §183(d).

6. The taxpayer's history of income or losses
7. The amount of occasional profit, if any (A profit objective is strongly indicated if the taxpayer has had a series of profitable years. In a majority of the cases resolved by the courts in favor of the IRS, the taxpayer **never** showed a profit.)
8. The financial status of the taxpayer (Does the taxpayer have another source of income, such as W-2 income, that is separate from the direct-seller activity?)
9. Elements of personal pleasure or recreation (Personal pleasure may coexist with the objective of making a profit, but if much of the taxpayer's activities involve elements that are personal in nature, such as visiting family members or friends who are also involved in the same business, the factor is more likely to favor the IRS.)

According to the retail industry ATG, the revenue agent may not tell the taxpayer that the losses are disallowed because it is not possible to make a profit with a particular business activity. Instead, the agent should thoroughly interview the taxpayer to gather sufficient information to evaluate each of the nine factors. The agent also considers an alternative position in the event that it is determined that the taxpayer did indeed have a profit motive. This alternative position is likely to include the disallowance of expenses deemed personal, and the taxpayer should be informed of any alternative position taken by the agent. The agent may attempt to secure a partial agreement to the issues in this alternative position.

FOOD AND BEVERAGE BUSINESSES

Chapter 4 of the retail industry ATG discusses examination techniques for food and beverage businesses. Some of these are discussed in the following section. The website **www.bizstats.com** states that 68% of food and beverage sole proprietorships report a net profit. Some industry averages include the following:

1. Total expenses are 89.1% of income.
2. Cost of goods sold is 42.5% of income.
3. Salaries and wages are 15.4% of income.

LIQUOR STORES

The retail industry ATG mentions other sources of receipts that are common for liquor stores. They include the following:

1. **Grocery Sales such as Cigarettes, Snacks, Food, and Candy.** The examiner can compare the gross receipts reported with those reported on state sales tax returns. There may also be an audit report from the state department of revenue.
2. **Sales of Lottery Tickets.** The income from lottery sales can be determined from the monthly reports by the state. A liquor store generally receives a commission on the sales of the tickets, as well as a percentage of winnings from winning tickets sold by the establishment.
3. **Check Cashing and Other Services under the Bank Secrecy Act.** The revenue agent asks about these services in the initial interview and inquires about the fee structure for cashing checks and/or the sale of money orders and wire transfers. The store may also receive a commission on the sale of stored value cards, such as prepaid telephone calling cards.

The retail industry ATG advises agents to consider using a percentage-markup method (as discussed earlier in the chapter). The taxpayer, especially in the liquor business, may be required to purchase goods for resale only from authorized distributors. If the taxpayer's records are unreliable, the agent can contact these suppliers directly to ensure that cost of goods sold (and the corresponding income from the sale of those goods) is not underreported.

PIZZA RESTAURANTS

The retail industry ATG instructs the agent to focus the examination on income and internal controls. A pizza restaurant is a cash intensive business in which family members or other employees can remove cash from the cash register before sales are recorded. The agent is alert for other sources of income such as delivery sales, carry-out business, and faxed/Internet orders to ensure that all sources of income are recorded and reported. The ATG also recommends that agents use the unit and volume method as previously discussed.

> **Example 14.** Revenue agent Dwight is examining Mike's Pizza, an owner-operated pizza restaurant where Mike is the only employee. Because Mike is not a good record keeper, Dwight decides to use the unit and volume method to determine whether income is accurately reported. He determines, after looking at invoices, that Mike purchased 10,000 pizza boxes during the year under audit. Mike had already stated in the initial interview that all of the boxes were purchased from one supplier. If Dwight does not feel that all of the invoices were kept, he could use third-party contact procedures to contact the supplier directly.
>
> After determining that the inventory of boxes was not a material factor at yearend, Dwight multiplies the $10.00 average pizza cost by the 10,000 pizza boxes used to arrive at a gross receipts figure of $100,000.

The agent obtains a copy of the menu to assist with determining the ingredients purchased. The **unit and volume method** is also used for various ingredients such as flour, cheese, and tomato sauce.

In the expense area, the agent looks for expenses paid with cash. The agent also looks to ensure that employment tax obligations were met, and that any necessary information returns were filed.

TAVERNS

The retail industry ATG advises agents that audit techniques for taverns and bars are dependent upon the quantity and quality of the taxpayer's books and records. If the taxpayer maintains inventory records which detail the purchases and sales of liquor, a liquor cost percentage can be computed and applied to total purchases to determine the gross receipts and gross profit of the establishment.

> **Example 15.** Revenue agent Dean examines Molly's tavern. Molly keeps all her invoices for expenses, but does not always use the cash register to ring up sales. She pays many of her expenses in cash, and does not deposit all her receipts.
>
> Dean decides to use a liquor cost percentage to determine gross receipts. He determines the cost of the most popular brands of liquor at $20 per gallon. One gallon has 128 ounces. Dean determined in the initial interview that Molly pours an average of 1½ ounces of liquor per drink. He computes that Molly is able to pour 85 drinks per gallon of liquor (128 ÷ 1½). If Molly sells the drinks for $3, her sales value per gallon is $255 (85 × $3).
>
> Dean determines a pouring cost percentage of approximately 8% ($20 cost per gallon ÷ $255 sales value per gallon). If Molly purchased $10,000 of liquor, the gross receipts would be $125,000 ($10,000 purchases ÷ 8% pouring cost percentage) before labor, facility, and other expenses.

If the establishment does not maintain detailed purchase and sales records, the agent relies on third-party information to verify purchases and compute the markup on cost. This markup is then applied to total purchases to estimate the gross receipts and gross profit of the establishment.

> **Example 16.** Revenue agent Dwight audits a small tavern. He determines in the initial interview that the markup percentage for alcohol sold is 80%. He examines the invoices provided by the owner and determines that total liquor purchases were $35,000 for the taxable year. Had these records not been reliable, Dwight could request the names of the vendors from the taxpayer and send letters to them requesting the records of purchases made by the taxpayer. Since the markup was determined at 80%, the total markup of $28,000 ($35,000 × 80%) is added to the total purchases of $35,000 to arrive at total gross receipts of $63,000 ($35,000 + $28,000).

These computations do not take into account items such as spillage or happy hour prices. In **Example 16,** Dwight must ask the owner during the initial interview about these policies so they can be considered when determining the estimated total gross receipts. This markup percentage could also be applied to each individual type of drink using various industry standards.

> **Example 17.** Revenue agent Dean is examining Sam's Bar, which is located within a restaurant and sells only draft beer. A quarter keg contains 992 ounces of beer and beer distributors calculate that approximately 93 servings are available after accounting for foam and spillage. A half keg contains 1,984 ounces of beer, and approximately 190 servings can be sold. After Dean confirms the price of the beer (as listed on the menu and confirmed by the owner during the initial interview), he divides the sales price by the size of glass in which the beer is sold in order to arrive at a sales price per ounce. He also determines the ounces in each glass and pitcher sold to arrive at total gross receipts. This technique can also be used if the taxpayer sells bottled or canned beer, or wine and wine coolers.

The revenue agent looks for income from coin-operated machines such as juke boxes, cigarette machines, pool tables, and video games. The general rule for these types of machines is that the income generated is split based on some percentage determined by the owner of the machine. Because this income is difficult to determine, the agent asks about any contracts and policies for these machines in the initial interview. The agent determines what potential income is present during his tour of the establishment.

Other types of income may include:

1. Rebates from suppliers
2. Sales of lottery tickets
3. Sales from gaming pools
4. Franchise rebates
5. Tenant allowances or fixture allowances
6. Advertising rebates or incentives
7. Sales of assets
8. Cover charges/admission fees
9. Room rentals for wedding receptions and other special events
10. Catering or banquets
11. Bartering
12. Kickbacks from vendors
13. Renting space for signs

The revenue agent should ask about these potential sources of income during the initial interview and during the tour of the business.

For cost of goods sold, the retail industry ATG describes various statistical and ratio analyses to use in the pre-audit stage of the examination. These normally indicate whether additional audit steps may be warranted. Once the agent conducts the initial interview and begins to examine the books and records, he determines whether those records can be relied upon or whether an indirect method is needed to determine gross income. These ratios include the following:

1. Gross profit percentage = (Gross sales – Cost of goods sold) ÷ Gross sales
2. Inventory turnover rate = Cost of goods sold ÷ ((Beginning inventory + Ending inventory) ÷ 2)
3. Percentage change in inventory = (Ending inventory – Beginning inventory) ÷ Beginning inventory
4. Food cost percentage = Food cost ÷ Food sales
5. Liquor cost percentage = Liquor cost ÷ Liquor sales
6. Sales per seat = Total sales ÷ Number of available seats
7. Sales per square foot = Total sales ÷ Square footage of tavern
8. Sales per labor hour = Total sales ÷ Number of full-time employees

The ATG recommends that these ratios be computed for the current year, prior year, and subsequent year (if applicable) and then compared to identify potential discrepancies.

GROCERY STORES

The retail industry ATG instructs agents to focus on income issues during the examination of a grocery store. Besides the sale of groceries, grocery store gross receipts may be attributed to other transactions:

1. Coupons and coupon processing
2. Rebates
3. Promotional gifts received
4. Cash discounts
5. Bottle and can redemptions
6. Check cashing
7. Money orders
8. Wire transfers
9. Video, DVD, and game rentals
10. Sales of prepaid telephone cards
11. Lottery sales
12. Rental of shelf space or floor space

OTHER CASH INTENSIVE BUSINESSES

BEAUTY SALONS

Chapter 10 of the cash intensive businesses ATG discusses the unique issues for beauty salons, barber shops, nail care parlors, skin care parlors, and massage parlors. These are cash intensive businesses that primarily provide a service and have a relatively small capital outlay to establish. In the ATG, the IRS estimated that, in 2001, these industries exceeded $25 billion in revenues. The examples in this section discuss beauty salons because the IRS estimated that $20 billion of this revenue comes from beauty salons. However, the techniques could be equally applicable to the other types of businesses mentioned.

As in other types of examinations, the agent attempts to reconcile the reported tax return income to the taxpayer's financial status, evaluate internal controls to determine the extent of the income probes to be used, and design a test to determine income from the information that is available. A tour of the business allows the agent to observe the different types of services offered, how many workstations are present, the appointment and payment procedures, and the price schedule for services offered.

Beauty salons typically have three main sources of income.

- Service income from hairstyling and other sources
- Retail income from product sales
- Booth rental income

The service income of any employees or independent contractors is reported on Form W-2 or Form 1099. The owner's receipts from services are computed by subtracting the employee receipts from total receipts. The revenue agent asks the salon owner how compensation is paid to salon employees. In order to compute the salon owner's service income, the agent asks about the owner's activity in the salon, the wage expense from the tax return, the employee commission percentage, and the total service income reported on the tax return. The total wage expense is divided by the commission percentage to determine the amount of employee service income. That amount is subtracted from the total service income (from the tax return) to arrive at the reported service income of the owner. This is compared to an appointment book and individual income records as well as statements given during the initial interview.

Example 18. Revenue agent Dwight examines a beauty salon, and attempts to determine the owner's service income. He already determined that the employee commission percentage for services is 60%, the wage expense is $60,000, and the total service revenue from the tax return is $135,000. The owner works at the salon five days per week.

Dwight computes employee service income by dividing the wages expense of $60,000 by the commission percentage of 60% to arrive at $100,000. Since the total reported service income is $135,000, the owner's portion is $35,000. Given that the owner worked 250 days during the year (50 weeks × 5 days per week) and had an average of eight appointments per day in the appointment book, the total number of service appointments is 2,000 (250 × 8). The service income per customer is computed by dividing the total of the owner's service income of $35,000 by the total appointments of 2,000 for an average of $17.50. The normal price for a basic haircut is $20 according to the schedule of fees, so Dwight suspects there might be up to $5,000 of unreported service income.

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The agent may reconstruct retail income from product sales:

1. Based on cost of goods sold, or
2. Based on commissions paid to employees.

Example 19. Revenue agents Dean and Dwight are examining Franco's Salon and attempting to determine the retail income from product sales. Dean uses the cost of goods sold method. He determines from the owner that there is a 90% markup on products sold. He adds the cost of goods sold of $20,000 to the markup amount of $18,000 (20,000 × 90%) to arrive at total retail sales of $38,000.

Dwight uses the commission method instead. He divides the total commission expense for product sales of $30,000 by the commission percentage of 75% to arrive at $40,000 of retail sales. This is very close to the cost of goods sold method. Because Franco only reported $25,000 in product sales, the agents suspect that this income is underreported.

The revenue agent must consider special sales on products and "walk-through" traffic when no specific worker receives a commission.

There is an additional formula that the agent may use to determine the amount of booth rental income. If all stylists are employees, there is no booth rental income. If all stylists are independent contractors, the salon owner is considered a landlord.

The appointment book is a key tool in the income probe of the agent. The revenue agent may ask the salon owner to review a sample period in the appointment book and explain the scheduling and recording procedures. There may be a system that designates the type of service scheduled and the hours and days worked by the employees or tenants.

In order to reconstruct the rental income, the revenue agent must determine the rate of rent, the number of stations in the salon, and the rent revenue per the tax return. The rate of rent is multiplied by the number of stations and also multiplied by 52 weeks to determine the total rental revenue. This amount must be adjusted if all the stations are not filled.

Example 20. In an examination of Leeza's Salon, revenue agents Dwight and Dean attempt to determine the amount of booth rental income. The agreement between Leeza and the stylists calls for a weekly rental of $130 per station. There are 10 stations in the salon. The stations are nearly always full. The rental rate of $130 is multiplied by 10 to arrive at a weekly total of $1,300. This amount is multiplied by 52 weeks to arrive at total rental income of $67,600. Given that the rental income reported by the owner was $65,000, the difference could be explained by occasional vacancies. The discrepancy is likely not large enough to become an audit issue.

The agent may raise the employee versus independent contractor issue for a beauty salon. The agent uses common-law factors to make this determination. In general, the agent attempts to determine the control that the owner has over the workers and whether that control is indicative of an employer/employee relationship.

Note. A detailed discussion of employees versus independent contractors can be found in the 2008 *University of Illinois Federal Tax Workbook* in Chapter 1, Employment Taxation. This can be found on the accompanying CD.

Tip income is another common audit issue in the beauty salon industry. As with other businesses, employees should report tips to their employers. The agent compares the amount of tips reported with the amount of service income for each worker to determine whether a potential issue exists. The agent inquires about tip income for the salon owner if the owner also provides services. The revenue agent asks in the initial interview about any tip records that are provided to the salon owner by the workers. If there are no records, the agent may try to determine a tip rate using charge slips, interviews of workers, industry practices, and observations.

Example 21. Agents Dwight and Dean try to determine the total tip income for the workers at the HubaHuba salon. No amounts were reported on the stylists' Forms W-2. The agents determine the tip-rate percentage on a sample of charge slips that include a tip added to the charge sale. They arrive at a tip percentage of 18%.

They allow for a smaller tip rate for cash sales and arrive at an overall tip rate of 16%. This is multiplied by the total service income of $100,000 to arrive at total tip income of $16,000. They can allocate this amount to the various stylists based on each worker's share of the total service income. In the event a stylist kept a contemporaneous record of tips and reported them, that amount (if reasonable) could be used instead of the formula.

This tip formula is used by the IRS in other industries where tipping is customary (restaurants, etc).

The cash intensive businesses ATG provides a detailed initial interview questionnaire and information document request for the agent. Taxpayers and practitioners may review this information in advance of an audit in order to be prepared for the types of questions that the revenue agent may ask.

CAR WASHES

In the examination of a car wash, the agent may use various comparative ratios in the pre-audit stage of the examination. The gross receipts vary depending on whether the wash is a self-service or full-service facility.

In order to test the gross receipts of a car wash, the agent may request any available daily sales summary sheets. These sheets itemize the number of cars washed, any other items sold, and the total cash collected. The agent selects a test period and reconciles the total receipts with the bank deposits. If the car wash has employees, it may install a "car counter" to ensure that employees are not embezzling money. The agent can use this count and the average price per car wash to determine the amount of gross receipts for the facility. If a car wash has only self-service bays, there may still be a counter system to determine how many cycles were utilized in the taxable year.

If there is a change machine that converts dollar bills to quarters or tokens, the revenue agent may attempt to use a formula to estimate income based upon the number of bills converted to coins or tokens. If the change machine only converts dollars into quarters, the agent must adjust for dollars that were converted but not deposited into the wash bay, as well as coins that did not originate with the change machine but were deposited into the car wash bay. This requires estimates that the owner or the agent will find difficult to support with facts.

The revenue agent is likely to use one of two consumption methods to reconstruct the taxpayer's income:

1. **Water Consumption Method.** The agent attempts to determine the number of gallons used per cycle and divide that number into the total water usage for the 12-month period to determine the number of car washes sold.
2. **Soap, or Chemical Consumption Method.** The agent determines how much soap or chemical is used for each car wash and divides that number into the total soap or chemical purchased for the 12-month period to determine the number of car washes sold.

The cash intensive businesses ATG provides an extensive list of potential interview questions and an information document request for the agent to use for the initial interview.

Example 22. Revenue agent Dwight examines a car wash. He determines the average water used per cycle by taking water meter readings before and after various cycles or groups of cycles, making adjustments for regular and deluxe washes because they consume different amounts of water.

He determines the total amount of water from the water bills for the business over the 12-month period, which covers slow and busy times, and a representation of all four seasons of the year (winter is usually the busiest season). The total water used for the year is divided by the average water used per cycle to determine the total number of washes for the year. This amount is multiplied by the average cost per wash to arrive at a gross receipts amount for washes. Any vacuum, vending, or product sale is added to determine gross receipts for the business.

Example 23. Revenue agent Dean examines the competing car wash business across the street. He determines from the owner that a 55-gallon drum of soap washes approximately 700 cars.

Dean determines the total number of drums used for the year from invoices. He multiplies that number by 700 to arrive at total washes for the year. That amount is then multiplied by the average price per wash to determine the gross receipts for the wash portion of that business.