MSSP

Market Segment Specialization Program

Bars and Restaurants

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

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

Department of the Treasury
Internal Revenue Service

Training 3149-118 (2/95)
TPDS 83849L

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BARS AND RESTAURANTS

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GLOSSARY

INTRODUCTION

The restaurant and bar examinations in Los Angeles District began as a Market Segment Specialization Program effort in General Program in which agents spent 10 to 15 percent of their time on those cases. Two types of establishments were included in the team's look at restaurants and bars: 1) Restaurants which served only food, and 2) Restaurants which also had a full bar available.

The examinations performed in Los Angeles showed the audit potential for restaurant and bar cases was not strong enough to warrant establishing a group to work such cases full time. The restaurant and bar returns examined were a mixture of Schedule C businesses and smaller corporations. Because the failure rate of restaurants is so high (approximately 80 percent of all restaurants fail within the first 2 years of business), adjustments made to the tax returns were often uncollectable or would have to be applied to a Net Operating Loss (NOL). Thus, the examiners completed the audits of the sample returns opened at the onset of the project and did not pursue the effort further.

The Boise, Idaho District expanded the Market Segment Specialization Program to include bars which served only some food items. These entities' largest revenues were generated primarily from the sale of beer, alcoholic beverages, and wine. The sale of food was generally an incidental source of revenues.

The size of the bars and restaurants examined in the Boise District ranged from larger franchise entities, to the smaller "Mom and Pop" type bars. The most successful examinations were of the locally owned bars. It was generally found that these entities dealt entirely in cash and had a great opportunity for underreporting income. About half the returns examined contained net operating losses.

This audit guideline summarizes some of the significant facts and issues the agents discovered from both the Los Angeles and Boise research studies of the industry and the related examinations.

This guide is intended to be used by revenue agents specializing in the bar and restaurant market area, and by any other examiners working in this area. Since these types of examinations mainly focus on basic income and employment tax issues, this guide can be used by examiners with all levels of experience. During the examination of the bar and restaurant returns, the examiner will encounter all levels of sophistication of the books and records by the taxpayer. Therefore, the examiner must decide whether a Balance Sheet approach or an Income Statement approach will be used for the examination. Both approaches are detailed in the guide.

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Chapter 1

BACKGROUND/GENERAL INFORMATION

OVERVIEW OF THE INDUSTRY

The bar and restaurant industry can be a very profitable business, or it can be very unprofitable. There are various forms of entities from small sole proprietorships to large corporations. The entities are sometimes run as franchises and are sometimes family owned and operated entities. The examiner may find a taxpayer who owns, manages, hires his family as employees, and has very little internal controls. The examiner may also find a management-operated entity with strict internal controls, definite segregation of duties and a very standard business structure.

Financial Aspects

The owner/operator should concern himself or herself with the potential start-up costs and enough operating capital to exist for several months until a customer base is established. The potential start-up costs could be very high. These costs could include: the purchase or lease of the business building, the equipment purchases, and initial inventory stock. The taxpayer may secure start-up money from a number of sources. The money may come from an inheritance, savings accounts, bank loans, small business administration, loan shark, and/or other investors (partners).

Once the decision to start the business is made, one of the tasks the owner/operator must perform is menu/drink pricing. Based on past examinations of bars and restaurants, this practice can be as easy as using prices which are the same or slightly lower than the competition's to figuring a profit percentage for each item. A typical pricing technique would consist of the following:

1. Determine the cost of the item.

2. Add a percentage for waste or spillage, for example 10 percent.

3. Add a percentage for inflation, for example 4 percent.

4. Multiply the total estimated cost by the desired profit percentages.

Example 1

1.	Cost: Margarita	.50
2.	10% spillage (.10 X .50)	.05
	Subtotal	.55
3.	4% Inflation (.04 X .55)	.02
	Total Estimated Cost	.57
4.	Desired Profit Percentage 500% (.57 X 5.00) Equals Sales Price	2.85

Once the restaurant/bar is established and is operating, the owner/operator must be aware of theft in the restaurant/bar.

OPERATING RATIOS

As with any industry, certain operating ratios can be computed using the standard costs found throughout the industry. As expected, the majority of the operating expenses in a bar and/or restaurant come from the food, liquor, and payroll expenditures. Therefore, in examining any bar and/or restaurant establishment, the focus of the exam will be on these expenditures. Other expenses that are also high are rent, property taxes, and insurance.

BOOKS AND RECORDS

As previously stated, due to the diversity of taxpayers in the bar and/or restaurant industry, a variety of books and records may be found during the examination. Some taxpayers will keep very detailed records of their purchases of food and liquor, describing the quantities purchased, the price paid, and when it was purchased. Other taxpayers will make purchases on an as needed basis only, and will not have any structured purchases journal and will usually only have canceled checks and/or invoices for the items purchased.

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

1. Daily Operating Reports

2. Check Register or Copies of Coded Voucher Checks

3. Bank Statement

4. Bank Reconciliation
5. Paid-Out Recaps (by Account Classification)
6. Ending Inventories (food, liquor, beer, wine)
7. Unpaid Bills Recap (vendor and account classification)
8. Equipment Purchases (include copy of invoice)
9. Payroll Summary
10. Accrued Payroll
11. Monthly and/or Quarterly Tax Returns
12. Copies of Daily and Weekly Profit and Loss Statements.

Many of the taxpayers keep daily envelopes with the cash paid out and the cash taken in recorded on the envelope. All invoices/receipts of the purchases of food and liquor are maintained in this daily envelope.

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Chapter 2

THE AUDIT

EXAMINATION

IRM 4231, Chapter 600, Text 6(16)0, "Examination Techniques Peculiar to Certain Small Businesses," provides some insight into the examination of restaurants or cafes. Read this text in the IRM before you begin as a way of becoming familiar with the basic concepts.

PRE-AUDIT PLAN

As with any pre-audit plan, an analysis of the tax return should be conducted for potential issues. Performing an analytical review will be very advantageous in determining potential issues. One form of analytical review, comparative balance sheets and income statements, will give meaning to the changes that took place between the years, as opposed to figures taken individually which are relatively meaningless. Large percentage changes or percentages that are not standard for the industry can be highlighted as potential issues and areas where the initial interview should focus. An important ratio that can be computed on the comparative income statement is the Gross Profit Ratio. It is computed from the following:

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

This ratio tells us approximately how much of an item's sale price represents gross profit and how much is a recovery of the cost of the item. During the initial interview, the taxpayer should be asked the mark-up percentage on the goods sold. The percentage obtained from the interview can be compared to the computed ratio to see if they are comparable. If not, this could be a possible indication that cost of goods may be overstated or revenues understated. An analysis of these accounts should be then performed to determine if this is the case.

All Schedule M items should be carefully reviewed to determine the reasons for differences between income shown on the books of the corporation and taxable income shown on the tax return.

INITIAL INTERVIEW

The initial interview should be conducted with the owner of the establishment. If the owner (majority shareholder) does not work in the establishment, the manager, who knows about the day-to-day operation, should also be interviewed. The primary objective is to acquire up-front information about the establishment and its normal operations. Information such as gross profit ratios, mark-up percentages on food and alcohol, and costs of food or alcohol items need to be addressed in the initial interview. This information is imperative in order to use the indirect methods discussed in the manual. Additional third party information is also needed for the indirect methods. You can find this discussed in the Exhibit 2-2.

Exhibit 2-3 provides a list of questions prepared for an interview of a bar and restaurant establishment. They represent a sample only. The examiner may want to add, subtract, or reorganize the questions depending on the type of examination.

INITIAL INFORMATION DOCUMENT REQUESTS (IDR'S)

The Information Document Requests (IDR's) should be prepared using the Form 4564. The Form 4564, Information Document Request, serves the following purposes:

1. Provides a written record of the information requested.

2. Provides the date of the request so follow-ups are timely.

3. Prevents the agent from requesting the same information on different requests.

Exhibit 2-1 is a sample of an IDR that can be used.

Exhbit 2-1

Form 4564 Rev. 6/88	Department of the Treasury Internal Revenue Service **INFORMATION DOCUMENT REQUEST**	Request Number
TO: Name of Taxpayer and Co. Div. or Branch **Please return Part 2 with listed documents to requester identified below.**		**Subject** Examination of 1120/1989 **SAIN No.** | **Submitted to:** **Dates of Previous Requests**

Description of Documents Requested

1. Copies of prior audit reports from either state or Federal agencies.
2. Workpapers used to prepare return, including trial balance and adjusting entries.
3. General ledger and all journals for the year ending December 31, 1989, including the chart of accounts and a schedule or journal of all purchases made during the year with the supporting invoices.
4. Copy of prior and subsequent Federal income tax returns.
5. Corporate minute book, organizational records, and stock record book.
6. Copies of Forms 940, 941, W-2, and 1099 for 1989 and 1990. Copies of current Forms W-4.
7. Copies of State Unemployment Tax Returns for 1989 and 1990.
8. Inventory records, including detailed ending inventory schedule.
9. Bank statements for all checking, savings, or brokerage accounts for the period December 1, 1988, through January 31, 1990.
10. Schedule of all loan proceeds, sources, and repayments.
11. Documentation of all nontaxable income.
12. Detailed depreciation schedule.
13. Copies of shareholder's individual returns for 1989 and 1990.
14. A tour of the business facilities during the first appointment.
15. Canceled checks and invoices to verify the following expenses:

Information Due By__________ At Next Appointment [ ] Mail In [ ]

FROM:	**Name and Title of Requester**	**Date**
	Office Location	

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Exhibit 2-2

THIRD PARTY SOURCES OF INFORMATION

The following represents possible third party sources of information that can aid you in the examination of bar and/or restaurant returns. The information may not be organized the same way in your state and additional information may be available in your state. You should research your state information to obtain the needed information.

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

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Questions Prepared for an Interview of a Bar and Restaurant Establishment

General Business

1. Who runs the business? Family-operated or management-operated?

2. What are the duties of those who run the business?

3. What amount of time does each individual spend at the business?

4. What type of reports are prepared for the business, and who prepares them? (i.e. tip reports, daily sales reports, etc.)

5. How much of the bookkeeping is done and/or kept at the business site? Does the owner have an accountant or bookkeeper who maintains his or her own bookkeeping system?

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

7. Does the management have any prior experience in the industry?

8. What are the days and hours of normal business operation?

9. What type of restaurant?

10. What type of clientele frequents the restaurant?

11. What is the customer capacity of the restaurant?

12. What are the average number of dinners sold on the weekdays and weekends?

13. What type of payment is accepted? (i.e. cash only, credit cards, checks)

14. What is the average cost of a meal?

15. Who determines the price of the meal?

16. What type of entertainment, if any, is offered?

17. Is there a cover charge for the bar or any entertainment, at any time during the evening?

    - How are the entertainers paid?

18. Are banquet facilities available?

19. Is there a set fee for banquets or is the charge determined on an individual basis?

20. Is there a "happy hour" (time period when alcoholic drinks are sold at a discount)?

    - Do you have any special pricing days?

21. Are food specials offered daily?

22. What are the average number of employees on the payroll?

23. How many people are working on day, afternoon, or night shifts for the various areas of the restaurant?

24. What type of hours do the employees work - day, afternoon, evening, etc?

25. How are employee's paid - weekly, biweekly, monthly?

26. Are any individuals working at the restaurant considered independent contractors?

27. How is time kept for the employees - sign-in, time clock?

28. What type of side duties, if any, do the employees have on a daily, weekly, or monthly basis?

29. Who calculates tips for each server?

Internal Controls - Inventory

1. Who are the primary suppliers of the business? What do they supply?

2. When are the purchases recorded? (daily, weekly, etc.)

3. Who is responsible for making the purchases?

4. Are the purchases recorded from checks or invoices?

5. What type of records are available for purchases? (Purchase Journal?)

6. Are there any records available for the number and size of bottles of alcohol purchased?

7. Are purchase discounts available? Were they taken?

8. Do the suppliers offer kickbacks or rebates? How are they recorded?

9. How many ounces of liquor are in each mixed drink? What are the prices of the mixed drinks?

10. Is the inventory of alcohol and food stored in a locked stockroom?

11. Who has access to the stockroom?

12. Who restocks the bar from the stockroom inventory and at what intervals?

13. What type of records are maintained when stock is removed from the stockroom?

14. Does the bartender have to turn in an empty bottle before she/he can receive a new bottle?

15. Who checks incoming merchandise into the stockroom?

16. Are contents of incoming cases verified?

17. Are automatic liquor dispensing devices used?

18. What is the price per beer for imported beer? Domestic?

19. If draft beer is available, how many ounces are in each drink? By the glass? By the pitcher?

20. Is there a price list of drinks available?

21. Do you have wine for sale, by glass and/or bottle? How many ounces are in each glass? Carafe? What are their prices?

22. What is the price of the wine coolers sold?

23. How many glasses of wine are served from each bottle?

24. What is the normal mark-up on mixed drinks? Beer? Wine? Wine coolers?

25. Do you compute spillage?

26. At what intervals are physical inventories of merchandise taken and who is responsible for it?

27. Is beginning bar inventory plus stockroom withdrawals less ending inventory periodically extended to retail prices and compared to receipts?

28. Who checks incoming inventory for the kitchen?

29. Are incoming shipments weighed?

30. Once the incoming inventory has been accounted for, what happens to the receiving document?

31. Do the employees eat on the premises?

32. Are they given the meals at a discount?

33. Are written records maintained for complimentary and employee consumed meals and drinks?

Internal Control - Cash

1. How are sales by the waiter staff controlled?

2. Are pre-numbered meal tickets used for each customer and/or table?

3. If so, how are they issued to each server?

4. What is each server's responsibility for the numbered meal tickets?

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

24. Who has access to the cash receipts?

Other Information

1. Who determines the prices of the meals offered?
2. How are portions controlled?
3. Do you have valet parking?
4. What happens to the money received?
5. What type of advertising is used?
6. Are there any promotions used?
7. What happens to the used grease?
8. Are there any coin-operated machines in the restaurant/bar?
9. What is the age and condition of the equipment?
10. What is the employee turnover?

Chapter 3

BALANCE SHEET

EXAMINATION

An examination of the balance sheet can be advantageous to detect certain items which might not be detected with just an examination of the income statement. However, depending on the size and sophistication of the bar and restaurant being examined, it might be cost beneficial to examine the income statement only, since a lot of the smaller establishments are on a cash-in cash-out basis.

If a balance sheet approach is taken, the following information can be used to conduct the examination.

This section provides a correlation between the balance sheet and the income statement. By proper planning of an examination, one can eliminate a duplication of effort and conduct a more thorough examination.

1. A detailed examination of accounts receivable can eliminate the sales cut off procedures of the income statement.

2. An analysis of the bad debt reserves on the balance sheet using the Black Motor Formula will determine if the provision to the bad debt reserve is reasonable.

3. An analysis of the debits of the prepaid assets will verify what items are being amortized or expensed.

4. A detailed examination of the fixed assets and the accumulated depreciation would eliminate the need to verify depreciation expense, verify the Schedule M-1 adjustment and the investment tax credit claimed.

5. Examining accounts payable can basically eliminate the need to audit the accrued amounts that were expensed on the income statement. Similarly, examining loans payable will eliminate the need to verify interest expense.

Audit Technique

The first step in examining the balance sheet is to prepare a comparative balance sheet analysis. Generally, a minimum of 3 years will be involved, the assigned year and the prior and subsequent years. These 3 years will provide 4 years of "end-of-year" balances.

The primary emphasis in the examination of the balance sheet is placed on the last year because it would eliminate the duplication of efforts for each year examined because of "rollovers." Rollovers are items which would affect the subsequent years if they were adjusted. It is at the agent's discretion whether prior years' balances are to be adjusted just for the interest due to the Government.

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

CASH

Cash in the bank should be reconciled between book balances and the bank statements. Generally the taxpayer's accountant will have bank reconciliations available to inspect or examine. The bank reconciliation(s) should then be reconciled to the tax return.

Unreported Income

Normal audit procedures such as tracing gross receipts to bank deposits, doing a bank deposit analysis of all business and (the owner/manager) personal bank accounts, etc. should be performed. However, it is important to remember that these type of establishments are a cash driven activity and that cash can be hard to tie down in any bank deposit analysis if the cash is not being deposited into the bank accounts. Therefore, it is important to tie down the cash that is collected as gross receipts from every source and cash that is paid out as expenditures. In the income statement section an indirect method is presented on how to audit the gross receipts from a bar and/or restaurant; however, consider the following techniques in auditing the cash on the balance sheet.

Audit Techniques

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

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

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

4. Determine if voided checks have been properly handled.

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

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

7. Determine whether the taxpayer has included interest income from time deposit accounts.

Stale Checks

Banks are generally not obligated to honor checks that are over 6 months old. Additionally, many customers either lose checks issued to them or just fail to present the checks for payment. If checks are outstanding for a prolonged period of time, the issue of liability should be raised. The taxpayer may no longer be liable for the outstanding checks. If no real expectation exists of the amounts ever having to be paid, then the amount(s) should be restored to income. As an alternative, the expense associated with the outstanding obligation or outstanding check(s) can be reversed and the check should no longer be carried as an outstanding check on the bank reconciliation. In other words debit cash and credit the expense.

Audit Techniques

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

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

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

INVENTORY

Inventories can be a large and material income producing item in the bar and restaurant area. A comment must be made in your work papers about its stated value on the tax return. Inventories on a bar and restaurant return would largely consist of food and alcohol items sold in the establishment.

IRM 4231 for Inventories

As required by IRM 4231, make the following minimum checks:

Extract

IRM 4231, Chapter 500, Text 5(10)2.2:2

* * * * * * *

(a) verify that any method of inventory valuation conforms to the "prescribed methods" as indicated in Regs. 1.471;

(b) compare inventory balances in the return with the balances for the prior and subsequent years' returns, and verify these with the taxpayer's records;

(c) check for unauthorized changes from cost to cost or market;

(d) check for gross profit percentage variations;

(e) determine meaning and significance of any notes or qualifying statements on financial reports prepared by independent accounting firms;

(f) determine that all direct and indirect overhead and burden expenses are in the overhead pool that is used in the computation of overhead rates where applicable;

(g) analyze unusual entries to cost of sales account for labor, material, and burden charges not directly related to sales or transfers of finished goods, if applicable;

(h) determine that year-end purchases were included in closing inventory;

(i) determine if there have been write downs for "excess" inventory to below cost. Verify that the method of inventory valuation for "excess" inventory is in accordance with Rev. Rul. 80-60; and

(j) determine that inventory costing conforms to Regs. 1.471-11 for taxpayers engaged in manufacturing or production activities. * * *

SAIN Discretionary Audit Procedures

1. Compare prior year closing inventory with current year opening inventory.

2. Determine whether a consistent and acceptable pricing method has been used.

3. Review manner in which overhead has been applied to inventories.

4. Review all inventory adjustments to assure that no premature write-downs or reserve of anticipated losses have been included therein.

5. Where obsolescence adjustments have been made, review usage for prior, current and subsequent years.

6. Where a standard cost system is used, review the factors comprising the standard frequency of updating and disposition of variances.

7. Test end of year purchases and accruals to assure inclusion of these items in inventory.

LOANS TO SHAREHOLDERS

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

Audit Techniques

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

SAIN Discretionary Audit Procedures

1. Analyze the composition of the account balance.

2. Trace the source of repayments.

3. Determine whether or not a bona fide debtor-creditor relationship exists.

4. Ascertain whether the current year's increase represents dividends.

5. Determine that interest income has been properly recorded.

6. Follow SAIN Program 218 (Loans from Shareholders/ Liability) where applicable.

FIXED ASSETS

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

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

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

Kitchen Equipment	Stove, grill, fryer, walk-in freezers, walk-in refrigerators, ovens, dishwashers, and storage equipment.
Office Equipment	Desk, computer and telephone.
Property	Fencing, building, and outside seating.
Dining Room	Tables, chairs, music (stereo/speakers), jukebox, cash register, floor coverings, salad bar, coffee makers, soda fountains, silverware, glassware, and dishes.
Bar	Refrigerators, cash register, sinks, bar, glassware, ice machine, ice bin, draft beer dispensers, alcohol dispensers, telephone, and coin-operated machines.

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

SAIN Discretionary Audit Procedures

1. Review the acquisitions to determine that basis has been properly recorded.

2. Where the acquisition consideration is other than cash, fully review the manner of arriving at basis.

3. Does the basis include all expenditures required to place the asset in readiness for operating use?

4. Allocations should be reviewed where a lump sum purchase price is involved.

   If there is an allocation in the contract between buyer and seller, verify that the allocation is consistent with the agreement. Also verify that the allocation reflects economic reality.

   If there was an acquisition of assets constituting a trade or business, IRC section 1060 may apply.

5. Consider the advisability of requesting Engineering assistance.

6. Review retirement policy and determine that receipts from dispositions are properly accounted for.

7. Determine company policy with respect to capitalization of minor items and record the information for future references in the Historical File.

Chapter 4

PROFIT OR LOSS STATEMENT

EXAMINATION

Examining the profit or loss statement may be the quickest and easiest way to perform an audit on a bar and/or restaurant. Some limitations of this approach might be in examining the gross receipts of the establishment. Since these establishments deal largely in cash, you will need to determine if the internal controls in place are adequate to ensure that the cash is being deposited into the bank accounts. Because of this uncertainty, an indirect method besides a bank deposit analysis may be warranted.

Audit Technique

The first step in examining the profit or loss statement is to prepare a comparative analysis. Generally, a minimum of 2 years will be involved; the assigned year and the subsequent year. Based on the analysis, unusual or significant fluctuations in account balances can be selected for a more detailed examination.

The primary emphasis of the examination of the profit or loss statement is placed on "permanent" types of issues. Permanent types of issues are contrary to the "rollover" type of issues and do not affect the subsequent year; for example, travel and entertainment, political contributions, investment tax credit, and investment tax credit recapture.

NOTE: Not all classifications of income or expenses are included in this package, which does not imply that the other items are correct or should not be audited.

SALES

The sales generated from a bar and/or restaurant can be generated from the following sources: Receipts from the sale of food, receipts from the sale of beverages (alcoholic and non-alcoholic) and receipts from coin-operated machines.

The sales generated from these sources are hard to trace since income is being generated by every customer and sometimes the level of sophistication of the books may be poor. To gauge the daily, weekly, or monthly performance of sales, the examiner will have to rely heavily on the information obtained in the initial interview, such as the number of meals sold in a typical day, average price of a meal, mark-up percentages on food and alcohol, etc. If the examiner can obtain accurate information in these areas, he or she will be able to accurately estimate what the sales should have been for a specific period. This estimate will enable the examiner to determine if unreported sales are possible. If it is discovered that underreporting exists, further detailed analysis of the information gathered will ensure that the underreporting can be adjusted in the examiner's report.

The indirect methods discussed in this section use information obtained from the taxpayer in the initial interview and from third party sources discussed in Chapter 2, Exhibit 2-1.

Since the bar/restaurant business is largely a cash-basis one, the use of the indirect methods discussed in this section may only uncover that an understatement of income exists, it may be hard or impossible to detect how the understatement was achieved. For example, the taxpayer may only be reporting income from one cash register when two are used, etc. The only way to possibly uncover this is to ask a lot of questions and keep your eyes open on the tour of the business. Another helpful technique would be to visit the operation during its normal business hours and observe how the transactions are handled.

<u>Income From the Sale of Food</u>

The formula below can provide a reasonable estimation of annual sales for the examiner to use in a comparison to figures on the tax return. The numbers used should be derived from the initial interview. Any large discrepancy between the income derived from these numbers and those reported on the tax return may indicate unreported income or inflated expenses. The examiner should then look closely at the pertinent accounts (such as food/beverage purchases, monthly sales, etc.) in the books and records.

Possible daily volume X Average check per seat = Daily Sales

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

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

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

-- Daily sales X Days open in a week = Weekly sales

-- Weekly sales X Weeks open in a year = Yearly sales

These estimates can be accurate if consideration is made for vacant seats and people who walkout before paying their bill. During the initial interview ask enough pertinent questions to determine if these or any other situations should be considered.

Normal audit procedures such as tracing gross receipts to bank deposits, doing a bank deposit analysis of all business and (the owner/manager) personal accounts, etc. should be performed. Consider the interview responses received concerning internal controls. Does the same person who counts the daily receipts also make the bank deposit? Are the meal orders taken on numbered tickets or would it be easy to simply not ring up a sale on the cash register for some orders? The examiner must look closely at the supervision habits in the restaurant to evaluate how sales might be understated or how easily theft may occur and by whom.

Another account to look at to test the accuracy of income reported is advertising. Are specials advertised? How often? Specials may refer to certain menu items or discounted prices or both. Are the times for which specials are offered (such as happy hour, weekly breakfast hours, etc.) reflected in the daily receipts ledger?

Cash Transaction Analysis, Net Worth, and Other Indirect Methods

A cash transaction analysis, net worth or other indirect method may be used to determine an understatement. However, as many of these methods rely on estimates, they must be supplemented if the case is to be sustained through the Appeals process. One possible way to further support as an indirect method in the case of a restaurant is for the examiner to inspect the supply invoices to find the name of the printer of the guest checks. This printer can provide the number of guest checks purchased by the restaurant in a year. A projected income can then be determined from the average amount of the guest check multiplied by the number of checks. If these methods are used in combination, they strengthen the case.

In the case of bars, it happens that, even in states where the distribution of liquor is carefully regulated, the bar owner may remove cash from his or her drawer, purchase liquor off the shelf of a store, sell the drinks in his or her establishment and return the amount of cash to the drawer while pocketing the profits. In such a case there usually will be no indication in the books that anything is wrong as neither the invoice or the income touches the books. An indirect method may uncover this.

Income From the Bar

As in any income tax examination, the auditing techniques used depend on the quality and quantity of the books and records maintained by the taxpayer. If the examination consists of a larger bar where there are inventory records maintained which detail the daily and/or monthly purchases and quantities sold, then the liquor cost percentage can be computed and applied to total purchases to determine the gross receipts and gross profit of the taxpayer. If the examination is of a smaller "Mom & Pop" type bar, chances are it is going to be time consuming and possibly difficult to determine the purchases for one day or one month. In this situation it might be better to partly rely on third party information to verify purchases and compute the mark-up on cost. The Mark-up can then be applied to total purchases to determine the gross receipts and gross profit of the taxpayer. Exhibit 4-1 provides a unit breakdown of liquors.

Using the Liquor Cost Percentage to Compute Gross Receipts

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

1. Determine the cost of some of the more popular brands of liquor.

2. Determine the sales value of the bottle if all liquor out of these bottles were sold.

3. Divide the sales value into the cost to get the potential pouring cost.

Example 1

Computing the liquor cost percentage.

1. Determine the cost of liquor.

   The taxpayer's records and verification from third party sources indicate that the cost per quart is $4.48.

2. Determine the sales value of the bottle.

   A quart has 32 ounces in it. If the taxpayer poured 1-1/4 ounces per drink, there would be 25.60 drinks per bottle. (32/1.25 = 25.60)

   If the taxpayer sold the drinks for $1.10, then the sales value per bottle less sales tax of $1.97 would be $26.19.
   (25.60 X $1.10 = $28.16 -$1.97 = $26.10)

3. Divide the sales value into the cost. This gives you the potential pouring cost.

$$\frac{\text{Cost}}{\text{Sales Value}} \quad \frac{\$4.48}{\$26.19} = 17.1 \text{ percent}$$

Conclusion: 17.1 percent of $26.19 is the cost. The rest is the mark-up. If this percentage is applied to total purchases of $5,000, the gross receipts should be $29,239.77. ($5,000/17.1% = $29,239.77)

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

Gross Profit (82.9%)	$24,239.77

Using the formula discussed above in Example 1, the computations could be used to calculate the total sales value of all bottles sold in a week or a month, etc.

Using the Mark-up on Cost to Compute the Gross Receipts

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

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

Example 2

Simplified example:	Sales Price	$10.00
	Cost	5.00
	Gross Profit	5.00

$$\text{Mark-up on cost} = \frac{\text{Sales Price}}{\text{Cost}} = \frac{\$10.00}{5.00} = 200\%$$

The following steps should be followed to compute gross receipts based on mark-up on cost.

1. Determine the mark-up of the various alcoholic items the taxpayer sells.

   The mark-up should be determined, if possible, in the initial interview. If the taxpayer does not know the mark-up of the bar items, you must compute it based on the sales price of drinks and the cost of the drinks. Figure 4-1 shows how to compute the mark-up of drinks.

2. Determine the purchases made by the taxpayer. Exhibit 4-2 provides a sample. You can get this information off the invoices provided by the taxpayer, if available and accurate. If accurate records are not available, you should request the names of all of the vendors from the taxpayer in the initial interview. Send letters to the vendors requesting all records of purchases made by the taxpayer in the years under examination.

3. Apply the mark-up to the purchases of the various types of alcohol.

   As in the earlier simplified Example 2:

   Mark-up = 200%
   Purchases and Total Costs = $ 5.00
   Cost = $ 5.00
   Sales Price = $10.00

$5.00 X 200% = $10.00 Projected Sales

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

Figure 4-1

SALES PRICE PER DRINK / COST PER DRINK = MARK-UP OF DRINK	
Computing the mark-ups on the various types of drinks	
Alcoholic Drinks	Sales Price per Drink -- Take an average of the more popular drinks served in the bar, per the taxpayer in the Initial Interview. It is important to determine in the initial interview the amount of alcohol in each drink. Cost per Drink -- Bottle Price / Number of drinks in bottle (See Exhibit 4-2) The bottle price is an average price of alcohol based on information from your local liquor dispensary.
Draft Beer	Sales price is based on the price of the beer per the taxpayer in the initial interview. Divide the sales price by the size of drink to get the sales price per ounce. It is important to determine the size of beers served, ounces in glasses, pitchers, etc. Cost of the beer is an average cost of beers available for sale by the taxpayer, sold in kegs, divided by the number of ounces in a keg (1,984 ounces). This gives the cost per ounce.
Bottled/ Canned Beer	Sales price of the bottled/canned beer is based on the price for the bottle or can per the taxpayer in the initial interview. Cost of the beer is an average cost of beers available for sale by the taxpayer. Bottles and cans usually sold by 12 pack or case (24), therefore, divide the cost by 12 or 24.
Wine	Sales price by the glass is based on the price per the taxpayer in the initial interview. Divide the sales price by the size of the glass to get sales price per ounce. It is important to determine in initial interview the ounces in each serving. Cost of the wine is an average cost of wine available for sale by the taxpayer. Wine can be sold by the bottle, box, or keg, therefore, take the cost of the unit divided by the number of ounces to get a cost per ounce.
Wine Coolers	Sales price by the bottle is based on the price per the taxpayer in the initial interview. Cost of the bottle is an average cost of wine available for sale by the taxpayer. Wine coolers are usually sold in case lots of 24. Divide the cost by 24 to get the cost per the bottle.

OTHER INCOME

Income from Coin-Operated Activities

Another important area in auditing income, is the receipts generated by the coin-operated machines located in a bar. Coin-operated machines may include juke boxes, cigarette machines, pool tables, dart boards, etc. These machines can be owned by the taxpayer or leased from another party. If the machines are leased, the general rule is that the income generated from the machines is split based on some percentage determined by the owner of the machine.

Income generated from coin-operated activities is very difficult to determine accurately. Therefore, it is important to ask a lot of pertinent questions in the initial interview regarding the operation and income generated from these machines. It may be necessary to secure third party information on this income. However, be careful of the reliability of these types of sources, since they may have arrangements with the taxpayers.

Other Activities

Other areas of producing possible income in a bar/restaurant is in the sale of lottery tickets, check cashing, cover charges, and gaming pools. Again close scrutiny must be made concerning these areas in the initial interview. Ask pertinent questions to determine if the taxpayer engages in these areas and how the cash is handled and reported on the tax return.

COST OF GOODS SOLD

The cost of goods sold can be one of the largest expenses on the return. The examiner should be aware that the purchase figure reported on the return may be a "plug" figure in order to balance the cost of goods sold computation.

The Internal Revenue Manual 4231, Chapter 500, Text 5(10)2.1 outlines minimum checks for purchases. (See extract below.)

Extract

IRM 4331, Chapter 500, Text 5(10)2.1 Purchases

(1) Review the cutoff date. Determine if year end purchases have been recorded in the proper accounting period.

(2) Determine if the owners consume or withdraw merchandise for personal use, such as food, liquor, appliances, etc. If so, proper reductions should be made to purchases or cost of sales. Also, consider the possible tax effect of such withdrawals to the recipients.

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

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

(5) Test check the recorded purchases for a representative period with vendor's invoices and canceled checks, etc. Be alert to such items as:

(a) personal expenditures; ***
(b) capital expenditures;

* * * * * * *

(6) If purchases are made from related taxpayers or controlled foreign entities, review a representative number of such transactions to determine if the following are present:

(a) prices in excess of fair market value;
(b) excessive rebates and allowances;
(c) goods or services not received ***.

(7) Ascertain if merchandise, prizes, trips, etc., were received from suppliers as a result of volume purchases.

Exhibit 4-1

Unit Breakdown of Liquor

The following items are unit breakdowns of liquor that is useful in computing liquor cost percentages or mark-up percentages.

Keg of Beer = 15 1/2 gallons = 1984 ounces
16 ounces = 1 pound = pint = 500 milliliters
32 ounces = 1 quart = 1 liter
128 ounces = 1 gallon
25.6 ounces = 1 fifth = 750 milliliters
1/2 gallon = 64 oz. = 1.75 liter
1.6 oz = miniature = 50 milliliters

		Number of drinks in bottle				
Metric Size	U.S. Fluid Oz.	3/4 oz.	1 oz.	1 1/8 oz.	1 1/4 oz.	1 ½ oz.
1.75 Liter	59.2	78.9	59.2	52.6	47.4	39.5
1 Liter	33.8	45.1	33.8	30.0	27.0	22.5
750 Milliliters	25.4	33.9	25.4	22.6	20.3	16.9
500 Milliliters	16.9	22.5	16.9	15.0	13.5	11.3
200 Milliliters	6.8	9.1	6.8	6.0	5.4	4.5

TAXPAYER'S NAME DATE
TAX FORM AND TAX YEAR KDC
JULY LIQUOR PURCHASES BY BOTTLE

LIQUOR BRAND	COST	NUMBER OF BOTTLES PURCHASED	TOTAL COST	SALES PRICE PER DRINK	NUMBER OF DRINKS PER BOTTLE	SALES VALUE/ BOTTLE	TOTAL SALES VALUE
FRANGELICO 64996	17.50	3	52.50	3.00	22.5	67.50	202.50
GALLIANO 65474	12.55	1	12.55	2.50	22.5	56.25	56.25
BLUE CURACO 85516	6.20	1	6.20	3.25	22.5	73.13	73.13
C BROS BRANDY 52316	8.05	7	56.35	2.25	22.5	50.63	354.38
BL BER BRANDY 54706	7.10	2	14.20	2.25	22.5	50.63	101.25
CHERRY BRANDY 55306	7.10	1	7.10	2.25	22.5	50.63	50.63
CR DE CACO DK 78166	7.05	3	21.15	2.50	22.5	56.25	168.75
CR DE CACO LT 78706	7.05	1	7.05	2.50	22.5	56.25	56.25
TANQUERAY 28866	13.80	10	138.00	3.00	22.5	67.50	675.00
BOMBAY SAPHIR 28236	14.80	2	29.60	3.00	22.5	67.50	135.00
BEEFEATER 28086	13.85	11	152.35	3.00	22.5	67.50	742.50
ABSOLUT 34006	13.15	3	39.45	3.00	22.5	67.50	202.50
STOLICHNAYA 34746	12.70	10	127.00	3.00	22.5	67.50	675.00
SO COMFORT 86886	7.90	3	23.70	2.50	22.5	56.25	168.75
AMARETTO 73946	8.65	5	43.25	2.75	22.5	61.88	309.38
VERMOUTHSWET 98744	6.20	1	6.20	2.25	22.5	50.63	50.63
BUSHMILLS 15776	14.90	10	149.00	3.00	22.5	67.50	675.00
KAHLUA 67526	14.75	22	324.50	2.75	22.5	61.88	1361.25
BAILEYS 68036	17.85	13	232.05	3.25	22.5	73.13	950.63
PEACH SCHNPS 82856	6.35	8	50.80	2.25	22.5	50.63	405.00
RASPBERRY 82146	5.70	1	5.70	2.25	22.5	50.63	50.63
CROWN ROYAL 11296	15.75	6	94.50	3.00	22.5	67.50	405.00
MAILBU 65726	8.65	20	173.00	2.75	22.5	61.88	1237.50
QUERVO GOLD 89196	10.70	13	139.10	2.75	22.5	61.88	804.38
CUTTY SARK 4796	15.70	7	109.90	3.00	22.5	67.50	472.50
DEWARS WHITE 4866	15.50	7	108.50	3.00	22.5	67.50	472.50
RED LABEL 5346	15.05	1	15.05	3.00	22.5	67.50	67.50
BACARDI LT 43126	8.00	6	48.00	2.75	22.5	61.88	371.25
BARCARDI DK 43036	8.00	3	24.00	2.75	22.5	61.88	185.63
MYERS DK 42166	10.95	5	54.75	2.75	22.5	61.88	309.38

LIQUOR BRAND	COST	NUMBER OF BOTTLES PURCHASED	TOTAL COST	SALES PRICE PER DRINK	NUMBER OF DRINKS PER BOTTLE	SALES VALUE/ BOTTLE	TOTAL SALES VALUE
YUKON JACK 67266	10.30	4	41.20	2.75	22.5	61.88	247.50
RUMPLE MINZE 69946	12.90	5	64.50	3.00	22.5	67.50	337.50
WILD TURKEY 22156	13.50	1	13.50	3.00	22.5	67.50	67.50
JIM BEAM 19066	7.35	1	7.35	2.50	22.5	56.25	56.25
EARLY TIMES 17826	7.05	1	7.05	2.50	22.5	56.25	56.25
JACK DANIELS 26806	10.95	27	295.65	2.75	22.5	61.88	1670.63
CANADIAN CLUB 10626	10.25	2	20.50	2.75	22.5	61.88	123.75
SEAGRAMS 7 25606	7.75	3	23.25	2.75	22.5	61.88	185.63
SEAGRAMS VO 11346	10.25	18	184.50	2.75	22.5	61.88	1113.75
CANADIAN MIST 12466	7.25	9	65.25	2.75	22.5	61.88	556.88
MACNAUGHTON 11066	6.75	11	74.25	2.75	22.5	61.88	680.63
BLACK VELVET 11876	7.10	23	163.30	2.75	22.5	61.88	1423.13
RICH & RARE 12886	7.05	3	21.15	3.75	22.5	84.38	253.13
GILBYS 30236	6.25	51	318.75	2.25	22.5	50.63	2581.88
MONTEGO BAY 45096	5.75	56	322.00	3.25	22.5	73.13	4095.00
KAMCHATKA 36536	5.10	143	729.30	2.50	22.5	56.25	8043.75
TRIPLE SEC 86016	5.65	14	79.10	3.25	22.5	73.13	1023.75
ARANDAS 87096	6.65	20	133.00	3.25	22.5	73.13	1462.50
USHERS 10276	9.70	30	291.00	3.75	22.5	84.38	2531.25
CANAD'N HUNTER 12326	6.70	40	268.00	3.75	22.5	84.38	3375.00
ARANDAS GAL 87098	14.65	4	58.60	3.25	52.6	170.95	683.80
PEPPERMINT 80686	6.10	6	36.60	2.25	22.5	50.63	303.75
GLENLVT SCOTCH 05036	23.75	2	47.50	3.00	22.5	67.50	135.00
APR TRIPLE SEC 85896	6.10	8	48.80	3.25	22.5	73.13	585.00
FLSMN ROYAL 35946	5.10	13	66.30	2.50	22.5	56.25	731.25
ARR TRPE SF 85896	3.70	4	14.80	3.25	22.5	73.13	292.50
CAN LTD 12406	6.25	2	12.50	3.00	22.5	67.50	135.00
TOTALS			5,673.20				44,541.93

MARK-UP FOR JULY (SALES PRICE/ COST = MARK-UP)

(44,541.93/5,673.20) = 7.85

Chapter 5

REQUIRED FILING CHECKS

EXAMINATION

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

IRM 4034

Required Filing Checks are as follow:

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

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

EMPLOYMENT TAXES

The restaurant and bar business is largely a cash business. As a result, many owners pay people for services rendered in cash. Two areas to consider in auditing these entities are cash paid to employees and cash paid to bands and/or other entertainers. The cash paid to the employees generally will not have employment taxes paid on it. The cash paid to the bands and/or other entertainers generally will not have a Form 1099 filed for it. Be sure that these areas are addressed in every examination of restaurants and bars. See Exhibit 5-1 for a list of interview questions to consider. This list is not all inclusive.

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

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

Tip Income

Form 8027 Employer's Annual Information Return of Tip Income and Allocated Tips - IRC Section 6053(c)

To increase tip income reporting compliance, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) enacted provisions which provide for substantial changes to reporting tip income earned by employees at large food and beverage establishments. For calendar year 1983 and later, employers at large food and beverage establishments are required to file Form 8027 (Employer's Annual Information Return of Tip Income and Allocated Tips) indicating the amount of gross receipts from food and beverage operations, total charge tips, and total charge receipts on which there were charged tips. See Exhibit 5-2 for a list of IRC sections that apply to tip income. In those establishments where employees report to their employer aggregate tips of less than 8 percent of gross receipts, the employer must allocate to the directly tipped employees the difference between 8 percent of gross receipts and the reported tips. The allocation will appear in Block 6 on the employee's Form W-2.

Large food and/or beverage establishments are required to make annual reports to the Internal Revenue Service concerning receipts from food or beverage operations and tips reported by employees. In certain circumstances the employer is required to allocate amounts as tips to employees. This reporting is done on Form 8027 (Employer's Annual Information Return of Tip Income and Allocated Tips). Large food and/or beverage establishments are defined as establishments where tipping is customary and which on a typical business day during the preceding calendar year, normally employed more than 10 employees (include all employees at all locations). An employee is defined as a full-time employee, based on the hours worked on a typical day. Since tipping is not customary at cafeterias or fast food operations, a return is notrequired for these. Exhibit 5-3 is a copy of the Form 8027.

Since most restaurants fall under the tip reporting rules, the examiner needs to ensure proper allocation has been made to the employees' wages. This audit step would be considered necessary to perform a quality audit. During the examination of the taxpayer, be sure to request a copy of the Form 8027 filed to ensure that a proper allocation has been made.

Allocation of Tips - IRC Section 6053(b)

As stated previously, an employer must allocate tips among employees who receive tips if the total tips reported to the employer during any payroll period are less than 8 percent of the employer's gross receipts for that period. Generally, the amount allocated is the difference between the total tips reported by employees and 8 percent of the gross receipts, other than non-allocable receipts. Non-allocable receipts are receipts for carry out sales and receipts with a service charge added of 10 percent or more. The amount allocated is for information purposes only and employers should not withhold income or social security taxes on that amount.

The allocation can be made under a good faith agreement or by using the gross receipts or hours worked methods. A good faith agreement is a written agreement between the employer and at least two-thirds of the employees of each occupational category of employees who receives tips (e.g. waiters and waitresses, busboys, maitre d's) working in the establishment when the agreement is adopted.

-- Directly tipped employees: Employees that receive tips directly from the customers, for example, waiters, waitresses, and bartenders.

-- Indirectly tipped employees: Employees that do not receive tips directly from customers, for example, busboys, service bartenders, and cooks.

The agreement must:

1. Provide for an allocation of the difference between total tips reported and 8 percent of gross receipts among employees who receive tips. This should approximate the actual distribution of tip income among the employees.

2. Be effective with the first day of a payroll period that begins after the date of adoption, but no later than January 1 of the next year.

3. Be adopted when there are employees in each occupational category who would be affected by the agreement. AND

4. Allow for revocation by a written agreement adopted by at least two-thirds of the employees in occupational categories affected by the agreement at the time of revocation. The revocation is effective only at the beginning of a payroll period.

If no good faith agreement applies to the payroll period, the employer must allocate the difference between total tips reported and 8 percent of gross receipts using the following formula:

1.	**Gross Receipts**		**-----------**
	Less: Carryouts	**----------**	
	Sales with mandatory tips	**----------**	
	Net tippable sales		**-----------**
	Times 8%		**X 0.08**
	Tips at 8%		**-----------**
2.	**Less: Tips reported by employees receiving indirect tips**		**-----------**
	Total Directly tipped employees' allocation		**-----------**
3.	**Employee breakout of tips:** [1]		
	Total Directly tipped employees' allocation		**-----------**
	Times Ratio of = employee's gross sales / all directly tipped employees' gross sales		**X---------**
	Directly tipped employee's share of allocated tips		**-----------**
4.	**Individual employee's tip allocation**		**-----------**
	Less: Tips employee reported for payroll period		**-----------**
	Individual employee's shortfall for period	**------------**	
5.	**Tips at 8% as figured in Step 1**		**------------**
	Less: Total tips reported by both directly and indirectly tipped employees		**------------**
	Amount to be allocated among the directly tipped employees with a shortfall (figured in step 4)		**------------**
6.	**Times Ratio of: employee's shortfall / total shortfall of all directly tipped employees**	**X**	**------------**
	Individual employee's tip allocation		**------------**

If after inspecting the allocation of tips and the tips reported by the employees you

[1] The employer may substitute the following for item No. 3 in the fraction described above: the number of hours worked by each employee who is tipped directly and total number of hours worked by all employees who are directly tipped for the payroll period.

3.	Employee breakout of tips:	
	Total Directly tipped employees' allocation	--------------
	Times Ratio of = total hours worked by directly tipped employee / total hours worked by all directly tipped employees	--------------

determine that further examination is warranted in order to correctly determine the tip income, a computation known as the McQuatters Formula can be used to compute the tip income.

Tip Rate Determination/Education Program

In October 1993, the National Office introduced the National Tip Rate Determination/Education Program. A program developed to improve the compliance of tipped employees in the food service industry.

The program is included in a Handbook entitled "National Tip Rate Determination/Education Program." The District Tip Coordinator in each district Examination Division has a copy of the handbook.

Overview of Program

The program involves executing a mutual agreement between the establishment owner and the district director, a "Tip Rate Determination Agreement." An accurate tip rate is determined by the establishment, validated by the district and used in subsequent periods by the tipped employees of the establishment. Working properly, the program will eliminate the need to audit participating employees returns.

For a copy of the "Tip Rate Determination Agreement (TRDA)", see Exhibit 5-3.

A 6 month calendar period is used to establish the tip rate(s) used in the agreement.

January 1, 19xx - June 30, 19xx or
July 1, 19xx - December 31, 19xx.

In order for the establishment to participate in the program, 75 percent of the tipped employees must sign a "Tipped Employee Participation Agreement (TEPA)" with the restaurant owner.

To participate in the program, the employees must:

Be current in filing and payment of tax on their individual income tax returns.

Continue to keep records of tips received and report at least the rate determined per the agreement.

The establishment is sent a Notice and Demand Letter for the Employer's share of FICA tax per IRC section 3121(q) on the unreported tips determined for the 6 month period used to establish the tip rate(s).

The Notice and Demand letter informs the employer of the unreported tips to be reported on the employer's Form 941 for the period in which the Notice and Demand is made.

Contact the District Tip Coordinator in the Examination Division. The coordinator will work with you to bring the restaurant into the program.

Examination Techniques Used to Determine Tip Income

If the establishment will not enter into a Tip Rate Determination Agreement, as described above, it will be necessary to conduct an employment examination of the establishment and all of the tipped employees.

The foundation for any tip examination is the McQuatters Formula. A result of the 1973 court case involving the employment tax examination of the restaurant located at the top of the Seattle Space Needle.

Discussion of McQuatters Formula

The McQuatters Formula is a statistically valid computation of unreported tips based on a 28 day sample of the restaurants charge tip receipts. The charge tip rate is established. Through interviews of restaurant management and tipped employees, the cash tip rate is established, typically .5 percent to 2 percent less than the charge tip rate.

This indirect method of determining tips was challenged in the courts. Although the computation was modified for various factors, the Service's overall methodology was upheld in the following court cases. See Exhibit 5-4 for a summary of each court case.

-- Mendelson v. Commissioner, 305 F.2d 519 (USCA 7)
-- Carroll F. Schroeder, 40 T.C. 30 (1963)
-- Sutherland v. Commissioner, 32 T.C. 862 (1959)
-- McQuatters, 32 CCH Tax Ct. Mem. 1122; 42 P-H Tax Ct. Mem. 1078 (1973).

SUMMARY

To make the computations used in the McQuatters Formula requires an in-depth analysis of the establishment's gross receipts and payroll records. Consult your Tip Coordinator for guidance before starting such an analysis. It also requires you to conduct very detailed interviews of management and employees. But most importantly it requires sound judgment in considering and accounting for all factors affecting the cash tip rate. If you do not perform your analysis properly, you will not be able to defend your proposed adjustments adequately. The techniques to properly document, analyze and gather information to determine tip income are summarized in Exhibit 5-5, Audit Program for Tip Income.

NOTE: Remember when opening an employment tax exam that there are other return statutes to protect. A Form SS-10 would be required in addition to the Form 872A for income tax.

Interview Questions

MANAGEMENT INTERVIEW

1. Days open:
2. Hours open:
3. Number of shifts?
4. Average number of employees on each shift?

   a. Captains
   b. Waitpersons
   c. Buspersons
   d. Other

5. Do employees work the same shift on a regular basis?
6. If not, how are shifts rotated?

   How are different shifts recorded?

7. Who sets up the room?
8. What is the average set-up time?
9. How is set-up time rotated?
10. If stations are not rotated, how are they assigned?
11. What is the seating capacity of the restaurant?
12. Are tips pooled and split among waitpersons?
13. How are tips split?

14. If tips are not split, to who and what percent are they tipped out?

15. How do customers pay for their meals? (i.e. do they pay the waitperson or pay on the way out?)

16. How do the employees receive their charge tips?

17. Do you have the following types of sales?

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

18. If you have the types of sales listed above, how do the employees receive any non-cash tips?

19. Are waitpersons required to pay for customers who leave without paying?

20. Does the average cash customer tip better or worse than the average charge customer? If so, by how much?

21. Do customers tip differently according to the time they eat?

22. Are there any unusual factors that affect tipping in your establishment?

23. Other Comments:

EMPLOYEE INTERVIEW

NAME OF EMPLOYEE INTERVIEWED:

1. Who was your manager?
2. How many shifts were there?
3. How many hours did you work in each shift?
4. Did all waitpersons work set-up and breakdown?
5. If not, who did and how long did it take?
6. Did you have a steady schedule?
7. Were shifts rotated?
8. How were they rotated?
9. How were stations assigned?
10. Were stations rotated?
11. How were they rotated?
12. What is the average number of tables per station?
13. What is the average number of chairs per station?
14. How many tables on the average did you serve per shift?
15. How many checks on the average did you write per shift?
16. Who assigns work stations?
17. Who assigns work shifts?

18. Does the average cash customer tip better or worse than the average charge customer? By how much?

19. Are tips pooled?

20. If so, how are they split?

21. If tips are not pooled, with whom do you share your tips?

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

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

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

23. On an average night, average week, or average month, how often would you get stiffed?

24. If a slow night occurred, was anyone sent home and how was this decided?

25. If sent home, did you get paid for the hours worked or a full shift?

26. Did you have to pay for walkouts?

27. If yes, how often did this happen?

28. What is your position?

29. What are your duties?

30. How long have you worked at this establishment?

31.Have you worked in any other position at this establishment?

32. Did you maintain records of tips you received?

33. If yes, what kind of records?

34. Was there a guaranteed tip rate at any time?

35. Did anyone work all large parties?

36. If yes, how was this determined?

37. Are customers who receive complimentary food or beverages better or worse tippers that the average customer?

38. Were checks written up so that you could be identified?

39. If so, how was this done?

40. As a food server, do you consider yourself above average, average, or below average?

41. Is there a reason why a determination of an average sales and tips would be unfair to you?

42. Other Comments:

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<u>Exhibit 5-2</u>

IRC SECTIONS WHICH APPLY TO TIP INCOME

Section 45B	General income tax credit for employer FICA taxes paid on employee tips. Effective 1994.
Section 61	Tips and gratuities are compensation for services rendered.
Section 119	Excludes from income meals furnished on the business premises of the employer for the convenience of the employer.
Section 446	Allows the IRS to compute income by a method which, in its opinion, does clearly reflect income.
Section 3101	Imposes a tax under the Federal Insurance Contributions Act.
Section 3121(q)	Tips included for both employee and employer taxes.
Section 6001	Taxpayers are required to keep records which are sufficient to enable the respondent to determine their correct tax liability. Such records must be retained by the taxpayer so long as the content thereof may become material in the administration of any internal revenue.
Section 6053	Imposes new reporting requirements with regard to tip income. Guidelines for the Form 8027.
Section 6652(c)	Allows for a 50 percent penalty for underreported FICA tax due to tips.
Section 6653(a)	Allows for a penalty for negligence or intentional disregard for the rules or regulations.

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Department of the Treasury-Internal Revenue Service
TIP RATE DETERMINATION AGREEMENT
____

____
____
(Taxpayer-Employer's name, address, and identifying number) and the District Director of Internal Revenue ("District") make the following agreement:

WHEREAS, by law, all employees who receive cash and or charge tips are required to keep timely and accurate records of tips received and to report the tips received to their employer on a monthly basis or other lesser period as the employer may require, and all tips received are required to be reported as income on the employees' federal income tax returns; and

WHEREAS, the District and ______________________________ , (hereinafter "Employer") have agreed to implement a program to ensure maximum compliance by the employees of the Employer with those provisions of the Internal Revenue Code of 1986, as amended, relating to tip income. This program will minimize the burden on the Employer resulting from tip compliance programs of the District and reduce the enforcement costs of the District; and

WHEREAS, the District and the Employer have agreed to resolve disputes concerning the responsibility of the Employer under 26 U.S.C. 3121(q) and establish procedures to prevent such disputes in the future;

NOW IT IS HEREBY DETERMINED AND AGREED for federal income and employment tax purposes as follows:

I. RECITALS

The foregoing recitals are made a part hereof.

II. DEFINITIONS

1) Employer as used herein is the employer named above.

2) Employee as used herein is a person employed by the Employer for at least 30 calendar days and who directly and or indirectly receives cash and or charge tips of at least $20.00 per month during the course of his or her employment.

III. EFFECTIVE DATE

This agreement is effective as of the date the last party to sign the agreement does so.

IV. EMPLOYEE PARTICIPATION

A. For purposes of this agreement, a "Participating Employee" is an employee who:

1) completes and files with the Employer on or before (month/day/year), the Tipped Employee Participation Agreement ("TEPA"), indicating his or her intent to participate in the tip reporting program; and

2) commencing in the year (year), reports and continues to report, his or her tips to the Employer (in compliance with Internal Revenue Code and Regulations) at or above the tip rates established pursuant to Section VII of this agreement.

B. If the employee is hired by the Employer after (month/day/year), he or she must indicate on the TEPA his or her election to participate in the program and file the TEPA with the Employer no later than 30 days after his or her date of hire. A copy of the TEPA is included as attachment "A" to this agreement.

C. The District will not examine an employee's tip income from (name of employer) for (year) or any subsequent year in which he or she is employed by this Employer and receives tip income if the employee completes and files with the Employer on or before (month/day/year), or within 30 days of his or her date of hire if later, the TEPA indicating his or her election to participate in the program. The employee must also comply with subparagraph A. 2) above.

An employee who revokes his or her TEPA may be subject to the full range of compliance and enforcement procedures of the Service.

V. NONPARTICIPATING EMPLOYEES

An employee other than a Participating Employee ("Nonparticipating Employee") is subject to the full range of compliance and enforcement procedures of the Internal Revenue Service.

VI. EMPLOYER PROGRAM

A. The Employer agrees to encourage all of its tipped employees to participate in the program.

B. The Employer will establish tip rates in accordance with Section VII of this agreement.

C. The Employer will make tax withholding based upon tips reported, as required by law.

D. The Employer will include all reported tips on Forms W-2 as "wages, tips, and other compensation."

E. On or before (month/day/year), and each March 2nd thereafter, the Employer will provide to the District in writing the following information on each Nonparticipating Employee: name, social security number, wages, shifts, hours and or sales, job categories, reported tips, and charged tips paid out. The Employer shall provide to the District additional information in the Employer's possession and control necessary to determine the tip rates of Nonparticipating Employees as requested.

Employers that report tip rates on subsequent years Forms 8027 (Employer's Annual Information Return of Tip Income and Allocated Tips) at or above the tip rates established for the Tip Rate Determination Agreement, will not be required to submit the information above.

F. The District will give Notice and Demand for the liability against the Employer for (year) pursuant to 26 U.S.C. 3121(q) based on tip income received by employees for the six month period beginning (Date) and ending (Date) which was used to determine the tip rate for (year).

Tip Rate Determination Agreement With (Name of Employer)

G. For the Employer to participate in this program:

1) 75% or more of all tip receiving employees must be Participating Employees on or before (month/day/year). Tip receiving employees with fewer than 30 days of service with the Employer as of (month/day/year), may be included in this calculation, but are not required to be included; and,

2) the Employer must document through the TEPA, payroll records, exceptionreports, and such similar records as the Employer must maintain, those employees who have elected to report their tips to the Employer in accordance with Section IV of this agreement.

H. To continue participation in this program for subsequent years, the Employer must have at least 75% or more of all tip receiving employees as Participating Employees on or before December 31st of each subsequent year. Tip receiving Employees with less than 30 days of service with the Employer as of December 31st of each subsequent year may be included for that year's calculation but are not required to be so included.

I. The District may assert liability against the Employer pursuant to 26 U.S.C. 3121(q) based on tips received by Nonparticipating Employees after (month/day/year), but only if such asserted liability is based upon the final results of an audit of a Nonparticipating Employee.

VII. TIP RATES

A. Initial tip rates will be established by the Employer prior to entering this agreement. The initial tip rates will be reviewed by the District. The District will notify the Employer in writing of its approval or will request additional information within 90 days of the date the Employer submits the initial rates to the District.

B. The tip rates will be determined based on information available to the Employer, historical information provided by the District and generally accepted accounting principles. If appropriate, the Employer will establish tip rates for categories or subcategories of employees. These tip rates will specify tips received by hour, sales, or by shift, depending on the nature of the work performed.

C. The charge tip rates are based on dividing the charge receipts (with tips) into the charge tips. Each year the Employer must retain charge receipts for those days specified as the 28 day sample set forth in attachment "B". The Employer must retain the 28 day sample charge receipts for the period specified in paragraph F. below.

D. The formula for the Employer to use to calculate the tip rates is set forth in attachment "C". This formula was derived from the Tax Court case McQuatters v. Commissioner, T.C. Memo 1973-240. The initial tip rates are set forth in attachment "D".

E. Each year as of December 31, the Employer will review the tip rates and will submit to the District within 90 days after December 31, either revised tip rates or a statement that no revision was necessary. Any revision submitted to the District will be reviewed and the District will notify the Employer in writing of its approval or request further information within 90 days after submission.

F. The Employer will maintain the records used to establish the initial tip rates and those used each year to determine the necessity of a revision. These records will be retained for at least four years after the later of: 1) the payment due date of applicable Income and FICA Tax for the return period to which the records relate; or 2) the date those taxes were paid. The Employer will make those records available to the District upon request.

VIII. TERMINATION OF THE AGREEMENT

This agreement may be terminated by either party to the agreement.

A. The District may terminate this agreement if, as of December 31, (year), and each December 31st thereafter, fewer than 75% of the tipped employees are Participating Employees. Nonparticipating Employees with fewer than 30 days of service with the Employer will not be included in this calculation.

B. If either party fails to comply with any provision of this agreement, the other party shall notify the noncomplying party of the defect. If the defect is not corrected within 30 days of notification, the notifying party may terminate the agreement by giving 30 days written notice to the noncomplying party.

C. If the parties fail to agree to revision of the tip rates, as set forth in Section VII of this agreement, within 90 days after the tip rates are submitted to the District, either party may terminate the agreement by giving 30 days written notice to the other party.

D. The mutual obligations of the parties hereunder shall cease 30 days after date of written notice by either party to terminate the agreement.

IX. MISCELLANEOUS

A. The agreements described herein, including but not limited to those agreements described above in paragraph IV. E. and paragraphs VI. F. and G. shall remain in effect if any other part of this agreement is found to be unenforceable, or beyond the authority of the District to include in the agreement.

B. All correspondence by the Employer pertaining to this agreement, including a notice of termination by the Employer to Internal Revenue Service, must be sent to Chief, Examination Division, Stop ______, __________________, _______, _____________. The Internal Revenue Service will send all correspondence pertaining to this agreement, including a notice of termination to the Employer, at the address stated below unless notified in writing by the Employer of a change of address.

By signing this agreement, the parties certify that they have read and agreed to the terms of this document, including all attachments hereto.

EMPLOYER:	INTERNAL REVENUE SERVICE
___________________________ (Name of Employer)	___________ District
___________________________ (Signature)	____________________ (Signature)
BY: ______________________	BY: __(Directors Name)____
TITLE: ___________________	TITLE: District Director
ADDRESS:	ADDRESS:
______________ (street address)	_____________ (street address)
______________ (city/state/zip)	_____________ (city/state/zip)
DATE: ____________________	DATE: ____________________

Attachment A of Tip Rate Determination Agreement With
(Name of Employer)

ATTACHMENT "A"

TIPPED EMPLOYEE PARTICIPATION AGREEMENT
"TEPA"
SUMMARY DATA

The District of the Internal Revenue Service ("District") is exploring new methods to achieve voluntary compliance with the tip reporting requirement. In the past, the District reviewed an employer's records and examined individual employees. This method was very time consuming for all parties involved.

The new program involves a cooperative effort by the District, ____________________ (the "Employer"), and you, the tipped employee. This new program provides for the following:

1. The Employer will calculate a tip rate based on historical data and the McQuatters Formula.

2. The District will review this rate.

3. Employees will participate by: (a) continuing to comply with the employee tip reporting requirement (i.e., a written statement must be supplied to the Employer to report tip income); (b) reporting tip income at or above the tip rates established in the Tip Rate Determination Agreement; and (c) having the Employer withhold the appropriate income tax and FICA tax.

4. Seventy-five percent of the tipped employees must be Participating Employees.

5. Employee's will maintain tip records, income tax returns and related information for at least four years after the later of: 1) the payment due date of applicable Income and FICA Tax for the return period to which the records relate; or 2) the date those taxes were paid.

6. The Employer will provide the District a list of names, social security numbers, wages, shifts, hours and or sales, and job categories of all Nonparticipating Employees by March 2nd of each year.

Attachment A of Tip Rate Determination Agreement With
(Name of Employer)

7. The District will not examine a Participating Employee's income tax return for underreported tip income received from (name of employer), if the Participating Employee is in compliance with the Tipped Employee Participation Agreement. The District may examine the tip records of a Participating Employee for compliance with this agreement.

Employees who do not participate in this program will be subject to examination to verify tips received.

Nothing in this agreement is intended to explicitly or implicitly create a contractual relationship between the undersigned employer and employee(s).

TIPPED EMPLOYEE PARTICIPATION AGREEMENT

I,_________________________, employed as a ______________________,
(print name) (job title)
wish to:

(check one) ( ) participate, ( ) not participate,
in the tip reporting program between _________________________ and the District.
(Restaurant/employer)

________________________________ ________________________________
Employee Social Security Number Employee home telephone Number

____
Employee Signature

____
Date

Attachment B of Tip Rate Determination Agreement With
(Name of Employer)

ATTACHMENT "B"

NON-LEAP YEAR SAMPLING DAYS

Quarter	1	1/2	1/15	1/31	2/11	2/24	3/22
		3/23					
	2	4/14	4/30	5/6	5/15	5/30	6/28
		6/29					
	3	7/24	8/5	9/1	9/13	9/24	9/17
		9/26					
	4	10/4	10/16	11/9	11/21	12/15	12/23
		12/31					

LEAP YEAR SAMPLING DAYS

Quarter	1	1/4	1/20	1/28	1/29	2/23	2/27
		3/20					
	2	4/12	4/15	4/20	4/23	5/5	5/9
		5/29					
	3	8/23	8/25	9/9	9/17	9/18	9/19
		9/21					
	4	10/4	10/8	10/16	11/18	11/24	12/26
		12/28					

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Attachment C of Tip Rate Determination Agreement With
(Name of Employer)

ATTACHMENT "C"

FORMULA FOR TIP RATE CALCULATION

Step 1: Determine charge and cash tip rates.

$$\text{Charge tip rate} = \frac{\text{Total charge tips}}{\text{Total charge sales with charge tips*}}$$

Less: Difference between charge and cash tips (attributable to smaller and fewer tips)

Equals: Cash tip rate

Step 2: Compute tips earned per hour/sale

1.	Gross sales subject to tipping	
2.	Less:	Stiff factor
3.		Charged sales with charged tips
4.		Other factors
5.	Equals:	Sales subject to cash tipping
6.	Multiply:	Cash tip rate
7.	Equals:	Cash tips received
8.	Added:	Charged tips
9.		Tips received from other employees
10.	Equals:	Total tips received
11.	Less:	Tip outs
12.	Equals:	Adjusted tips
13.	Divide:	Total hours worked or total sales $
14.	Equals:	Tip rate per hour or sales $

Indirectly tipped employees

Compute tip rate per hour

$$\text{Tip rate per hour} = \frac{\text{Tips received from other workers}}{\text{Total hours worked}}$$

* If this figure is unavailable, use "Total Charge Sales" for the denominator of the charge tip rate.

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Attachment D of Tip Rate Determination Agreement With
(Name of Employer)

ATTACHMENT "D"

INITIAL TIP RATES

Section 45B Credit
Food and Beverage Workers

CATEGORY	RATE	
Host/Hostess		%
Food Servers		%
Cocktail Servers		%
Bartenders		%
Room Service Food Servers		%
Bus Persons	$	per hour
Others	$	per hour

Non Section 45B Credit
Food & Beverage

CATEGORY	RATE	
Bellman	$	per hour
Valet	$	per hour
Others	$	per hour

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SUMMARIES OF SIGNIFICANT COURT CASES

Mendelson v. Commissioner, 305 F.2d 519 (USCA 7)

> Where a taxpayer keeps no records disclosing his income, no method can be devised which will produce an exact result. The law does not require that much. It is sufficient if the method employed produces a result which is substantially correct. All taxpayers, including the one here involved, by failure to keep records of their income assume the hazard that they may be called upon to pay a tax based on an income which cannot be determined to a certainty. Such a situation, however, arises from the fault of the taxpayer and not that of the Commissioner.

Carroll F. Schroeder v. Commissioner, 40 T.C. 30 (1963)

> Tips constitute compensation for services rendered and, therefore, are includible in gross income under section 61(a) of the Internal Revenue Code of 1954. *Roberts v. Commissioner*, 176 F.2d 221 (C.A. 9. 1949), *affirming* 10 T.C. 581 (1948); *Mendelson v. Commissioner,* 305 F. 2d 519 (C.A. 7, 1962), *affirming a Memorandum Opinion of this Court, certiorari denied* 371 U.S. 877 (1962). What is at issue then is the amount of tips received by the petitioner during 1957 and 1958.

Sutherland v. Commissioner, 32 T.C. 862 (1959)

> Having determined that the petitioner did not have any records of her tip income, the Commissioner used his statutory authority under Section 446 of the Internal Revenue Code of 1954, to make a computation of the amount of petitioner's tips for the years involved in accordance with a method which in his opinion did clearly reflect such income. The method used by the Service to determine the tip income was not arbitrary or capricious, as asserted by petitioner, but was the best and most realistic method that could have been used with the information available.

McQuatters v. Commissioner, 32 CCH Tax Ct. Mem 1122; 42 P-H Tax Ct. Mem. 1078 (1973)

> The court addressed specifically the factors to be considered in determining a tip rate and the types of items for making a reduction. The court stated: " *** None of the petitioners has claimed that she did a significantly greater amount of low tipping work (serving banquets or lunches or working in the cocktail lounge) than the other petitioners. Accordingly, we believe that respondent's flat rate approach to all petitioners is appropriate. Respondent's 12 percent rate is based upon the fact that charge customers of the Space Needle who also charged their tips gave tips equaling slightly more than 14 percent of the cost of their food and beverages. Such customers accounted for about one-fifth of the restaurant's total sales for two months in 1968. Respondent reduced the rate to 12 percent to account for the facts that cash customers usually left smaller and fewer tips than charge customers, that petitioners shared their tips with the captains, and that low tipping work like banquets was not charged. *** Although we are reluctant to extricate petitioners from the predicaments caused by their own lack of records, we do believe that petitioners have justified an additional two percent reduction in the rate to be applied. We are convinced that petitioners gave 10 to 15 percent of their tips to the captains and that to account for this and other factors respondent's formula should be applied with a 10 percent rather than a 12 percent rate of tipping. Accordingly, we hold that the amounts of tip income determined by respondent for each petitioner should be reduced by one-sixth."

Feldman v. Commissioner, 47 CCH Tax Ct. Mem. 776; 52 P-H Tax Ct. Mem. 3272 (1983)

> The court determined that the Commissioner's formula was reasonable, but it made two downward adjustments for evidence presented by the taxpayer which showed that she earned smaller tips on cash sales and paid a larger percentage to busboys than the Commissioner had determined.

Marvin v. Commissioner, Trevis L. Rorie and Sherilyn Rorie v. Commissioner, 41 CCH Tax Ct. Mem. 369; 49 P-h Tax Ct. Mem 2176 (1980)

> Underreported tips were reconstructed at 12 percent by Commissioner but lowered and assessed at 9 percent by court. A 5 percent negligence penalty was assessed. Taxpayer had no records of tip income. Court upheld that the tips recorded on the taxpayer's time cards every 2 weeks do not constitute "records." The taxpayer produced records in court but they were not accepted since they looked recently fabricated. Tip percentage reduced to 9 percent by court for the following reasons:

1) 12 percent of charged receipts included no tips and it is not fair to assume that a cash tip had been left, and 2) only 30 percent of total sales had been charged and the general opinion was that cash customers tipped less.

McInnis v. Commissioner, 41 CCH Tax Ct. Mem. 744; 50 P-H Tax Ct. Mem. 60 (1981)

Commissioner proposed 10 percent tip rate, court reduced tip rate to 7 percent due to this particular waitress's shift. The taxpayer proved she worked 8 p.m. shift which mainly serviced younger people returning from bars who largely ordered inexpensive items and did not tip as much as patrons during conventional meal hours. Nonetheless, the negligence penalty was still assessed.

Meneguzzo v. Commissioner, 43 T.C. 824(a) (1965)

Tax Court reduced Commissioner's tip rate to include lack of seniority, language difficulty or inferior stations.

Morgan v. Commissioner, 41 CCH Tax Ct. Mem. 332; 49 P-H Tax Ct. Mem. 2141 (1980)

Restaurant had minimum charge per customer. Number of total yearly customers was determined by record of checks. Tip rate determined by total year's charged tips, guaranteed tips and coupon customers. Determined total food and beverage sales/year; reduced by 20 percent to account for stiffs; multiplied the adjusted sales by tip rate and further reduced by 16.6 percentto account for tip-outs. The adjusted tips were thendivided by total hours of all waiters and waitresses.

Yukimura v. Commissioner, 43 CCH Tax Ct. Mem. 467; 51 P-H Tax Ct. Mem. 220 (1982)

The case follows our methodology exactly. It points out several key areas which related to tip income projects.

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Exhibit 5-5

Audit Program for Tip Income

1. Interview Management and Employees	Interview knowledgeable individuals to determine the tipping practices and factors causing differences between charge and cash tip rates.
2. Order Returns	In event of tip adjustments, order all returns for directly and indirectly tipped employees using the information from the W-2's.
3. Verify Sales Information	Identify those sales subject to tipping. Separate, when necessary, sales subject to tipping at different rates or earned by different categories of directly tipped employees.
4. Determine Charge Tip Rate	Use the Form 8027 if establishment filed an accurate return. Use a "28-day" sample if establishment does not have adequately organized records. See Exhibit 5-3, Tip Rate Determination Agreement for details on the "28-day" sample. Document evidence of employee tips.

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GLOSSARY

GENERAL TERMS

Call Drink -- A drink made with a name-brand liquor.

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

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

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

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

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

Net Purchase Price -- The price paid by the restaurant for one unit (i.e., pound, package, container, etc.)

Portion Cost -- The unit cost times the portion served.

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

Shrinkage -- The amount lost as a result of cooking.

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

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

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

TIP INCOME RELATED TERMS

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

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

Indirectly Tipped Employee -- This is an employee who receives tips from directly tipped employees through either tip pooling or tip splitting.

Payouts -- Same as tip-outs.

Server Assistants (S/A) -- This is a term used in a number of restaurants to describe buspersons.

Service Bar -- This service bar makes drinks for the waiter/waitress or cocktail waiter/waitress to serve but does not serve customers directly. Therefore, the bartender of a service bar is only indirectly tipped.

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

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

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

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

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

COMPUTATION OF KEY PERCENTAGES

Bar Supplies divided by Bar Sales = Bar Supplies Cost Percentage

Beer Cost divided by Beer Sales = Beer Cost Percentage

Food Cost divided by Food Sales = Food Cost Percentage

Labor divided by Total Sales = Labor Cost Percentage

Liquor Cost divided by Liquor Sales = Liquor Cost Percentage

Paper Cost divided by Food Sales = Paper Cost Percentage

Other divided by Total Sales = Other Cost Percentage

Wine Cost divided by Wine Sales = Wine Cost Percentage