



## Market Segment Specialization Program



# Beauty and Barber Shops

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## **Beauty and Barber Shops**

### **INTRODUCTION**

This beauty salon guide is composed of collective information from audits conducted in Las Vegas, interviews of salon owners, and contacts with the State Board of Cosmetology (Nevada, Oregon, and New Jersey). This guide is intended to provide an overview of the industry.

The salon industry is cash intensive. The majority of the work force has a high school education and are graduates from cosmetology school. The books and records provided are often limited. Overall, the examiner is faced with a cash business and few if any records. The preceding characteristics can be overcome by conducting a good initial interview, preparing a standard of living analysis, and utilizing an innovation method (see Exhibits 1-3 for possible variable) of determining income.

Each examination will be unique and challenging. The examination should not be entirely comprised of reconciling the books to return, evaluating internal controls, documenting your understanding, and testing the established controls.

Additional consideration are:

- Reconciling the reported tax return income to the taxpayer's financial status.
- Evaluating the intensive cash situation to determine the extent of the income probe.
- Designing a test to determine income from a reported of known reliable variable directly relating to income (see Exhibits 1-3 for examples).

### **INITIAL INTERVIEW and INFORMATION DOCUMENT REQUEST**

This section will focus on the questions and records designed for the salon industry. The standard interview procedures from IRM 4235-520 will not be addressed in this section.

## Interview Guide

Secure answers to the following questions:

### **Rental Revenue (Booth Rentals)**

1. How many stations are in the salon?
2. How many locations are there for the salon?
3. What type of stations are in the salon?
4. How many different types of stations in the salon?
5. How many of each type of station are in the salon?
6. Are the stations leased?
7. If the stations are leased - what was the occupancy rate of the stations for the year under audit?

### **Service Revenue**

1. How many employees are in the salon?
2. What are the appointments procedures?
3. How are the employees compensated?
4. How is compensation determined?
5. Do you have a tanning bed? How many?
6. Do you have a facial table? How many?
7. What are the sources of shop revenue?
8. What are your busy months? Slow months?
9. What type of services does the salon offer and what are the standard prices?
10. How many clients make appointments?
11. Operational questions:
  - a. How are walk-ins, cancellations, and no shows designated in the appointment book?

- b. What is the customer tracking system?
  - c. Do you maintain customer cards?
  - d. Is there a daily/weekly report for each individual?
12. What is the procedure for handling inventory?

**Salon Owner**

- 1. What type of hairstylist is the salon owner?
- 2. How many days a week does the owner work?
- 3. What specific days?
- 4. What type of services are provided?
- 5. How often are the appointments booked?

**Retail Revenue**

- 1. Are there retail sales?
- 2. What is the percentage mark-up on products?
- 3. What is the gross profit percentage?
- 4. What percentage is sold to "walk-through" traffic?
- 5. Are commissions paid to the individuals selling products?
- 6. What is the percentage paid as commissions on retail sales?
- 7. Who supplies the retail products?
- 8. Does the salon have its own line of products?

**Employee vs. Independent Contractor**

- 1. How many receptionists are employed?
- 2. How is the weekly/monthly rental rate determined?
- 3. How much is the weekly/monthly rental rate?

4. Does the individual rent a particular space?
5. Who is responsible for damage to the chair?
6. Is there a maintenance charge for the lease?
7. Are there price requirements for the lease?
8. Who maintains the individual's appointment book?
9. Who collects the money earned by the individuals?
10. Who pays for the individual's supplies?
11. Who maintains the books and records of the individual?
12. Who pays for the phone system in the salon?
13. How many phone lines are in the salon?
14. Are there any manicurists?
15. Compensation?
16. Are there assistants who only wash hair?
17. How are the assistants compensated?

#### **Information Document Request**

Refer to IRM 4231-650 for explanations for the following salon records:

1. Appointments Book(s)
2. Schedules or worksheets for individuals
3. Cash box receipts
4. Copies of each service slips
5. Lease agreement for stations (booths)
6. Franchise Fee agreements
7. Completed Form 4822 (Personal living expense)
8. Tip diaries

## **INCOME**

The income section of this guide focuses on unique examination techniques. Traditional auditing techniques are not discussed. For Cash-T or personal living expense evaluation, refer to IRM 4231-800 or IRM 4235-643.

### **Salon Revenue**

Salon revenue can be comprised of several sources or just one. Sources of revenue can include, but are not limited to, service revenue, retail revenue, and rental revenue. Normally, a salon's income will be broken down by type of revenue. If there is no break down, the specific revenue from each source can be determined by using algebraic formulas (refer to Exhibits 1-3).

#### **Service Revenue**

Service revenue includes the salon owner's and employees' revenue. Service revenue can be broken down into the specific employees' revenue and thus segregating the salon owner's revenue. The salaries/wages of the employees are normally based on productivity (only one salon audited in Las Vegas did not use productivity as a basis for compensation). Ask the salon owner for an explanation of compensation. Some type of productivity record is generally used to determine compensation - request that record or an explanation in writing. Compensation can be based on a commission, a straight salary, or a salary/commission combination. Once the composition has been determined, an algebraic formula can be structured to calculate the related income for the employees (refer to Exhibit 1 for formula). Once the salon owner's reported revenue has been identified, an income analysis can be completed (refer to Exhibit 1).

#### **Retail Revenue**

There are two methods in reconstructing retail revenue. The first method is based on Cost of Goods Sold (COGS). Retail revenue is directly related to COGS. Most products are marked-up 100 percent. An examiner can take COGS and double the expense, which can then be used as a gauge for retail revenue (refer to Exhibit 2 for calculation).



A second method for reconstructing retail revenue is based on commission. A common practice in the salon industry is to pay a 10-15 percent commission to the seller. Be ALERT -- remember the commission expense might include wages and thus you have an employee vs. independent contractor issue (see section on Employee vs. Independent contractor). Based on the commission expense an algebraic formula can be structured and used to determine retail sales (refer to Exhibit 2 for the formula).

An examiner has two items to consider when reconstructing retail sales: 1) consideration for special sales on products (there might not be a 100 percent mark-up) and 2) consideration for "walk-through" traffic where no specific worker receives a commission.

It is worth reiterating that the two previous audit techniques are guides and not absolutes. However, they have been effective in the examinations in Las Vegas. Using the techniques, adjustment were made to the individual (booth renter) who failed to report his or her commission income. In the situations encountered, Forms 1099 were not issued by the salon owner for the Commissions paid. In addition, salon income was also adjusted. The salon had understated retail revenue. The first indication of a potential problem was noted through the COGS percentage comparison.

### **Rental Revenue**

If the salon has all booth rentals, the salon owner is a landlord. Verify the available space and the amount that is occupied.

### **Appointment Book**

An appointment book can be used as a tool in an income probe. Have the salon owner or individual (the individual may be a stylist or some type of worker providing a service) go through a day in the appointment book and explain the scheduling and recording procedure for appointments. Normally, there is a coding system used to designate the type of service scheduled and whether or not the customer kept the appointment. For example, the barber may enter the customer's name for a regular cut, the customer's name may be circled for a style and a "b" may be placed by the customer's name to indicate a beard trim. Each salon has its own scheduling and recording procedures.

It is crucial to ask in the initial interview about the types of services provided (cuts, perms) and the scheduling procedures (walk-ins, set appointments). Also, ask the salon owner about the salon activity. The salon owner may remember busy or slow months. Verify the statements by looking in the appointment book and reconcile the statements to the income reported.

#### **Example 1**

Frank, a barber stated that he worked 5 days a week. However, by reviewing the appointment book, it was determined that he actually worked 6 days a week. However, consistent with his statement, but inconsistent with the appointment book, he reported only income from the operation of 5 of the 6 days.

Another important examination step is to compare the type of services and the number of appointments to the amount of income reported. The salon should have a list of services and prices. Services provided could include: hair cuts, shampoo/style, perms, hair color, nail services, skin care/facials, make-up hair removal, tanning, massage, etc. Compare the services provided with the standard prices. Exhibit 1 shows an example to calculate the average appointment price. By calculating the average appointment price, that amount can be compared to the standard prices charged in the salon. This technique is not an absolute, but can indicate potential income problems.

In addition to the appointment book, the barber may also maintain a daily income summary. In some situations, it was found the income amount determined through the appointment book was very close to the correct income. However, in other situations, by using only the appointment book, income was understated. In one case, it was found that the daily income was understated by about \$300 due to numerous walk-in appointments not recorded in the appointment book. In that situation, the barber had, however, recorded the correct income in the daily income summary. The point is that while the appointment book is an important document to like at, it may not reflect all services actually rendered. Therefore, it is important to analyze it in conjunction with other available records.

### Indirect Methods

Agents should be aware that indirect methods of proof are not favored unless the taxpayer's book and records do not exist or are incomplete and a likely source of income is identified.

The Service's authority to use an indirect method is contained in section 446(b) of the Code and Treas. Reg. section 1.446.(b). The Service does not have unlimited discretion to use an indirect method. An indirect method should be used only when:

1. The taxpayer has no books and records or incomplete books and records. Incomplete means not sufficient for the examiner to perform a meaningful audit.

This issue should be documented in the workpapers. If a taxpayer's books and records are inadequate, the examiner should prepare a detailed inventory of the books provided and why they are inadequate.

2. The examiner tests the books and records provided by the taxpayer (for example, with a "Cash-T" method) and determines that they do not accurately reflect income. While use of the Cash-T method may not always, in itself, be used as evidence of the correct tax liability, it can be used a basis for the Service reconstructing the taxpayer's income using one of the other methods.

Identification of likely sources of unreported income is generally necessary for the Service to sustain an indirect method of deficiency. Courts have upheld the Service in situations in which the taxpayers have likely sources of income and no books and records. Careful documentation of the investigation is essential in sustaining a deficiency in such a case.

### Fraud

The San Francisco District developed a draft audit techniques handbook for Laundromat which is quoted below.

"There is case law in which ONE indirect method can by itself be used to determine income and substantiate the civil fraud penalty. IRC section 446(b) states that the IRS can compute income if the taxpayer's method does not clearly reflect income.

There are TWO burdens of proof in civil fraud case. The FIRST is on the taxpayer to rebut the proposed deficiency. If the taxpayer cannot rebut the proposed deficiency through a plausible explanation for the discrepancy and adequate records, the court should find in favor of the Government.

The SECOND burden of proof is on the Government as to the imposition of the civil fraud penalty. Where the understatement is proven by ONE indirect method alone, the civil fraud penalty has been sustained where:

1. There is a pattern of substantial understatement in more than one year;
2. There is an absence of adequate records;
3. The Tax Court is not satisfied that the books and records reflect actual profit;
4. The taxpayer cannot rebut the reconstruction of income;
5. The taxpayer engages in activities to hide the facts as to his or her income, such as:
  - a. Making gifts without filing appropriate gift tax return;
  - b. Depositing skimmed funds into accounts of family members;
  - c. Hiding assets;
  - d. Paying employees (including family members) in cash;
  - e. Paying personal living expenses and business expenses in cash; and,
  - f. Making misleading and false statements during the audit in an attempt to conceal income."

## **EMPLOYEE VS. INDEPENDENT CONTRACTOR**

This section discusses the common law factors and relief under Section 530, State Regulatory Authority, revenue rulings, and court cases.

### **Common Law Factors**

The question of whether an individual is an independent contractor or an employee is one fact to be determined upon consideration of the facts and application of the law and regulations in a particular case. See Professional & Executive Leasing V. Commissioner, 89, T.C. 225, 232 (1987), aff'd 862 F.2d 751 (9th Cir. 1988); Simpson v. Commissioner, 64 T.C. 974m 984 (1975). Guides for determining the existence of that status are found in three substantially similar sections of the Employment Tax Regulations; namely, section 31.3121(d)-1, 31.3306(i)-1, and 31.304(c)-1, relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding, respectively.

In general, it should be noted that section 3121(d)(2) of the Internal Revenue Code requires the application of the common law rules in determining the employer-employee relationship. In determining whether an individual is an employee under the common law rules, 20 factors have been identified as indicating whether sufficient control is present to establish an employer-employee relationship. The 20 factors have been developed based on an examination of cases and rulings considering whether an individual is an employee. The degree of importance of each factor varies depending on the occupation and the factual context in which services are performed. See Rev. Rule. 87-41, 1987-1 C.B.; IRM Exhibit 4640-1, Employer-Employee Relationship. The 20 factors are not to be applied blindly. Rather, they are to be used as an aid in applying the common law.

Although a variety of factors may be used to analyze employment status for tax purposes, the regulations provide that employer control over the manner in which the work is performed is probably the most important. The test is not the actual control by the employer but the employer's right to control.

For further assistance regarding employment tax issues, contact the employment tax coordinator.

After it has been determined that an examination of the employee/independent contractor issue will be undertaken, section 530 should be addressed as early as practicable. Section 5309A(1) of the Revenue Act of 1978 terminates an employer's liability for employment taxes under subtitle C which includes FICA, FUTA, and income tax withholding, and any interest or penalties attributable to the liability for employment taxes. Section 530 provides that, for employment tax purposes, an individual will be deemed not to be an employee unless the employer had no reasonable basis for treating the individual as other than an employee. The purpose of section 530 is to shield employers who had a reasonable basis for treating workers as independent contractors from employment tax consequences arising from employment status reclassification by the Service.

For an employer to be eligible for relief under section 530: (1) all required information returns must have been filed on a timely basis (for example, Forms 1099); (2) the employer must not have treated any other workers holding a substantially similar position as employees after 1978; and (3) the employer must have had a reasonable basis for not treating the workers as employees. IRM Exhibit 4640-3, Section 530 Flowchart, may be used to assess the examiner in determining if relief under section 530 is available to the employer.

The employer may establish a reasonable basis for not treating the workers as employees by relying on any one of the three safe havens under section 530(a)(2):

1. Judicial precedent, published rulings, or a technical advise memorandum or a private letter ruling with respect to the taxpayer; or
2. Prior Service audit of the taxpayer; or
3. Long-standing recognized practice of a significant segment of the industry ("industry practice") in which the worker is engaged.

As early as possible during the examination, it is important to discuss with the taxpayer the reasons the workers are treated as independent contractors. During the discussion, the examiner should keep notes of the taxpayer's responses. A taxpayer cannot have relied upon recently decided cases as the basis for treating workers as independent contractors for years prior to those decisions. An opinion letter from an attorney

written after the examination began is less persuasive than one that was written when the employer first began using workers and treated them as independent contractors. The taxpayer has the burden of establishing industry practice based upon objective criteria substantiated by the taxpayer.

For example, in General Investment Corporation v. United States, 823 F. 2d 337 (9th Cir. 1987), the court held that a mining company had a reasonable basis for treating miners as independent contractors because the taxpayer had substantiated that the practice of treating miners as independent contractors was both long standing and well recognized within a significant segment of the local mining industry.

For further assistance regarding section 530 issues, contact Branch 2 of the Office of Associate Chief Counsel (Employee Benefits and Exempt Organizations) at (202) 622-6040.

### **State Regulatory Authority**

While the Service is not bound by State laws or determinations on this issue, State laws and regulations may be helpful to the examiner in analyzing the facts. The salon industry is regulated by each State Board of Cosmetology. Most states have a set of regulations.

For example, New Jersey regulations do not allow the holder of a shop license to rent space (a booth or chair) to a nonemployee (an independent Contractor). In Oregon, rentals are allowed if the renter is an independent Contractor. In Florida, while salons and barber shops must obtain a license from the Board of Professional Regulation, a booth renter is not required to be licensed by the Board. However, Florida's legislation had a bill pending, at the writing of this guide, that would require booth renters to be licensed with the Board of Professional Regulation. The bill in Florida is a trend started in the salon industry to regulate their booth renters. Check with the state regulatory board to help facilitate in determining the independent contractor and employee issue.

### **Revenue Rulings and Court Cases**

Review the following revenue rulings and court cases that address the employee vs. independent contractor issue:

**Revenue Ruling 57-110, 1957-1 C.B. 329**

Facts: Fixed weekly fee; owner furnished heat, light, water and supplies; barber provides own tools; barber sets own hours of work; and barber collects his own money and does not account to the salon owner for revenue earned.

Determination: Independent contractor

**Revenue Ruling 70-488, 1970-2 C.B. 219**

Facts: Barber is paid a percentage of the money from services performed; salon sets hours of work; required to wear a uniform.

Determination: Employee

**Revenue Ruling 73-591, 1973-2 C.B. 337**

Facts: Salon agrees to furnish, repair, and maintain all equipment; hair stylist is paid on a percentage of gross receipts; no credit work or free work can be done without the approval of the salon owner; working hours are set; hair stylist furnished a report each day to the owner reflecting the day's receipts.

Determination: Employee

**Revenue Ruling 73-592, 1973-2 C.B. 338**

Facts: Rents for a fixed monthly fee; the salon furnished heat, light, water, and supplies, hair stylist retains the money collected; hair stylist sets own hours of work.

Determination: Independent Contractor

**Wolfe v. United States, 77-1 U.S.T.C ¶ 9346 (D.N.D. 1977)**

Facts: Hair stylists are paid on a percentage of gross receipts; hair stylists handle own clients; hair stylists provide own supplies; appointments are made through one receptionist; hair stylists set their own hours and have their own keys to the shop; money from services is paid to the salon; hair stylist decides what prices to charge; hair stylists are responsible



for bounced checks; and hair stylist are not required to work on salon's customers.  
Decision: Employee

**A Henry, d.b.a Center Beauty Shop, 78-1 U.S.T.C.**  
**¶ 9433 (E.D. Tenn 1978)**

Facts: Rent is based on a percentage of gross receipts; no receptionist; anyone in the salon will answer the phone; salon furnishes the supplies; hair stylists collect own money; hair stylists set own hours of work; prices were set by an agreement among the hair stylist; and minimum rent payment is \$50.  
Determination: Independent Contractor

The following is Tax Management's summary of the issue based on revenue rulings and court cases.

" \* \* \* the one factor which appears to hold overriding persuasive value in the case of hair stylists is the nature of the remuneration under the agreement between the hair stylist and the shop owner \* \* \* the factors tending to show an employee relationship seemed to predominate over independent contractor type factors in those situations where the remuneration is based on a percentage of earnings, whereas the opposite is true in those situations where the hair stylists rents the chair for a fixed monthly fee."

**TIPS**

Workers in the salon industry supplement their base compensation with tip income. Per sample audits completed in Las Vegas, tips were reported as high as 22 percent of gross sales. Per industry literature, a conservative tip rate was 7.5 percent. A major casino's salon in Las Vegas agreed to a tip rate of 8 percent. Salon owners may state that they do not receive tips and thus have a 0 percent tip rate. The challenge with this issue is determining a reasonably correct rate. This section discusses determining a tip rate and calculating tips.

IRC section 61 defines tips as reportable and taxable income. Per IRC section 6053(a), there are reporting

requirements for tip income. An employee is required to give his or her employer a written report of his or her tips for each month by the 10th day of the next month. This report is required for each month that an employee receives tips of \$20 or more while working for that employer.

IRC section 3121(q) pertains to the employer FICA taxes with respect to tips received by its employees. IRC section 3121(q) states that tips are remuneration and are deemed paid by the employer to the employee. If the employee reports the tips to the employer, they are deemed paid when they are reported. Thus, the reporting rules, the deposit rules, and the contribution bases and rates are all applied as of the date the tips are reported by the employee to the employer.

Section 3121(q) also states that, if the employee fails to report tips or incorrectly reports them, the tips are deemed paid when the employee received them. This received date governs for all purposes, but it does not govern any provisions under subtitle F that pertain to employer FICA taxes. (Subtitle F sets out the procedure and administration rules, including the reporting requirements and deposit requirements.) For purposes of employer FICA taxes and subtitle F, if the employee does not report the tips, they are deemed paid when the Secretary makes notice and demand to the employer. This is not a notice and demand under section 6303(a). It is a special section 3121(q) notice and demand. Thus, the date of the section 3121(q) notice and demand controls the date on which the employer deposits the employer FICA taxes and the Form 941 on which the employer reports the tips. (Because section 3121(q) is located in Subtitle C, the special rule does not apply to the contribution bases and the tax rates; the employer must look to the year in which the tips were received for these figures.)

Rev. Rule 95-7, published in early 1995, deals specifically with section 3121(q). The revenue ruling contains Q&A's, and would be worthwhile for examiners to look at it for additional guidance.

### **Determining a Tip Rate**

On the initial information document request, tip records should be requested (tip diaries, etc.). However, tip rates can also be determined without diaries, by using the following information to determine a tip rate:

- charge slips
- interviews
- industry practice
- observations.

Review the following court cases that address the tip issue:

Bartell v. Commissioner, 48 TCM 461 (1984), T.C. Memo. 1984-346

Hair stylist in Lord and Taylor Store, Fifth Avenue, New York City, reported the same amount of tips every month in 1978. Commissioner estimated tips at 15 percent of gross sales based on a 1978 nationwide survey of tip income received by service industry employees. Tax Court accepted Commissioner's estimate with slight modification.

Becerra v. Commissioner, 28 TCM 108 (1969), T.C. Memo. 1969-22

Case involved a beautician in San Francisco department store in 1965. Commissioner reconstructed tips based on estimate of 8 percent of gross sales, supported by testimony salon manager and co-worker. Tax Court found this estimate reasonable under the evidence presented at trial.

Brancalone v. Commissioner, 22 TCM 1676 (1963), T.C. Memo. 1963-318

Beautician in Macy's Department Store kept no record of tips for 1959. Tips received by fellow beauty operator indicates generally whether tips were small or large. Commissioner's method of reconstruction not discussed.

Keller v. Commissioner, 48 TCM 332 (1984), T.C. Memo. 1984-314

Commissioner estimated tip income at 7.5 percent of gross sales based on average of co-workers' reported

tips. Taxpayer had no tip record and Commissioner's reconstruction was upheld.

Payne v. Commissioner, 23 TCM 670 (1964), T.C. Memo. 1964-119

Taxpayer, a co-worker of Brancalone, reported 2 percent of gross sales earned by him as tips for 1960 (pursuant to his daily record). Commissioner asserted that tips were 20 percent rate. Although doubtful of reported tips, the Tax Court found for the taxpayer.

**Calculating Unreported Tips**

The easiest way to determine unreported tips is to calculate the tip rate based on a percentage of service revenue. Determine the best source of information, for example copies of charge slips may be used. Select a sample (that is, 1 month) and calculate the average percentage of tips, for example:

<u>Service</u>	Price	<u>Tip</u>	<u>Tip%</u>
Hair Cut	\$ 30	\$ 5	16.67%
Perm	80	5	6.25%
Frost	<u>40</u>	<u>4</u>	<u>10.00%</u>
Total	\$150	\$14	32.92%

$$\frac{\text{Total Tip \%}}{\text{Total \# of Sample}} = \text{Average Tip \%}$$

Total Service Income	\$
Times Average Tip %	<u>        </u> %
Tip Income	\$

**Example 2**

Total Tip % = 32.92% = 10.97 average tip %

Total # of Sample 3

Total Service Income  
(from Tax Return) = \$ 47,000.00

Times Average Tip % = 10.97

Tip Income = \$ 5,156.00

**OTHER AUDIT CONSIDERATIONS**

Based on the trends in the salon industry, the following are other audit considerations for the salon industry.

1. The State Boards of Cosmetology

Certain State Boards of Cosmetology (Board) are extremely cooperative and are capable of providing information. Each licensee will have a file at the Board that has a current address and social security number. Also, the Board inspects and prepares an inspection report for each salon. Review the inspection report for useful audit information.

2. Retail Sales -- Inventory Issue

The trend in the salon industry is to start or increase retail sales. This potentially will generate an increase in inventory issues.

3. Booth Rentals -- Potential Non-filers

With the increase in booth rentals, there is a strong possibility that the non-filing of Federal tax returns will increase. The State Board of Cosmetology should have information on which salons have rentals. The Board should also have a list of licenses in the shop at the last inspection. With this list check IDRS and identify the nonfilers.

4. Computer Software for Salons

A Florida examiner, audited a salon that had computer software that was specifically designed

for a salon. The software accumulated on a daily basis a complete record of each sale. The record of each sale included the employee's name, the customer's name, the services rendered, retail sale detail and whether the sale was cash, check, or credit.

The examiner found that some customers paid by check or credit card and then added the tip to the total. The cashier then gave the cash difference to the customer. The customer then gave the tip personally to the stylist. The software accumulated these types of cash transactions into a separate daily account. From this information, it was a simple matter to trace the tip back to the total amount paid for services and calculate a tip percentage. By using the software package, the examiner was able to determine a tip rate between 7 percent and 9 percent.

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**Service Revenue Formula**

**Information needed:**

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

**Formula:**

$$\text{Employee Service Revenue} = \frac{\text{Wage Expense}}{\text{Commission \%}}$$

Total Service Revenue (from tax return)	\$
minus Employee Service Revenue	_____
equals Reported Service Revenue of Owner	\$
	_____
	_____

**Analysis of Service Revenue Reported:**

Compare to initial interview, appointment book, and individual income records.



**Example:  
Service Revenue Formula**

**Information provided:**

Employee Commission Percent = 60%  
 Owner's activity in salon = 5 days full time  
 Wage expense form the tax return = \$60,000  
 Service revenue from tax return = \$135,000

**Formula:**

Employee Service Revenue = \$60,000 = \$100,000

60%

Total Service Revenue from the tax return	\$135,000
minus Employee Service Revenue	100,000
	\$ 35,000

equals Reported Service Revenue of Owner                      \$ 35,000

**Analysis of Reported Service Revenue:**

Appointment book average 8 appointments per day. Assuming 2 two weeks of vacation, then 50 weeks were worked.

50 weeks per year  
 x 5 days worked per week  
 -----  
 = 250 days worked per year

250 days worked per year  
 x 8 appointments per day  
 -----  
 =2000 appointments per year

\$35,000 = \$17.50 average price per appointment

2000 appointments

The \$17.50 is a gauge. The average is not an absolute value. The average may allow an auditor to identify large discrepancies that could lead to potential unreported income.

Also assume the salon has the following standard prices: cut \$25, perm \$55, and color \$30. The average price per appointment is \$17.50. This would indicate a potential for unreported income since the actual prices for the individual services are above the computed average price per appointment.

**Retail Revenue Formulas**

**Information needed:**

- 1) Commissions Expense from tax return
- 2) Commission percent paid on retail sales
- 3) Cost of Goods Sold (COGS) per tax return
- 4) Retail Revenue per tax return

**Formulas:**

- 1)  $\text{COGS} \times 2 = \text{Potential retail Revenue (Assuming 100\% markup)}$
- 2) 
$$\text{Retail Revenue} = \frac{\text{Commission Expense}}{\text{Commission percent paid on sales}} \text{Employee}$$

**Example:  
Retail Revenue Formula**

**Information provided:**

Commission Expense per Tax Return = \$15,000  
Commission Percent = 15%  
COGS = \$53,000  
Retail Revenue per Tax return = \$105,000

**Formula:**

COGS x 2 = \$ Potential Retail Revenue  
\$53,000 x 2 = \$ 106,000

$$\begin{array}{r} \text{Retail Revenue} = \quad \text{Commission Expense} \\ \quad \quad \quad \frac{\text{Employee Commission Percent paid}}{\quad \quad \quad} \\ \quad \quad \quad \frac{\$15,000}{\quad \quad \quad} \\ \quad \quad \quad \frac{\quad \quad \quad}{15\%} \end{array}$$

Retail Revenue = \$100,000

**Analysis of Reported Retail Revenue:**

- 1) There is a percent mark-up on cost. The industry practice is 100 percent mark-up on cost. This mark-up percent is reasonable.
- 2) The commission expense reported on the tax return indicates retail revenue should be at least \$100,000.

Note: Small amounts of skimming are not easily identified. These two formulas were designed to identify large discrepancies.

**Rental Revenue Formula**

**Information Needed:**

- 1) Flat rate of rent
- 2) Number of Stations
- 3) Rent Revenue per Tax Return

**Formula:**

Flat Rent Paid X Number of Stations X 52 Weeks = Rental Revenue  
( adjust for vacancy rate )

**Analysis of Rent Revenue Reported**

Total Rent Revenue Reported  
\_\_\_\_\_ = \$ per week  
52 Weeks

\$ per week  
\_\_\_\_\_  
# of stations = Amount Reported per Station

**Example  
Rental Revenue Formula**

**Information Needed:**

- 1) Flat Rate of Rent per Station = \$130
- 2) Number of Stations = 10
- 3) Rent Revenue per Tax Return = \$65,000

**Formula:**

$$\text{Flat Rent Paid} \times \text{Number of Stations} \times 52 \text{ weeks} = \text{Rental Revenue}$$
$$\$130 \times 10 \times 52 = \$67,600$$

**Analysis of Rent Revenue Reported:**

$$\frac{\text{Total Rent Revenue Reported}}{52 \text{ weeks}} = \$ \text{ per week}$$

$$\frac{\$65,000}{52} = \$1250 \text{ per week}$$

$$\frac{\$ \text{ per week}}{\# \text{ of stations}} = \text{amount reported per station}$$

$$\frac{\$1,250}{10} = \$125 \text{ reported per station}$$

Compare the flat rate of rent per station and the reported rate per station. In this particular example, \$130 compared to \$125 is reasonable. The objective of this comparison is to identify large discrepancies between the flat rate of rent and the reported rate of rent.

## GLOSSARY

**APPOINTMENT BOOK** -- A record that contains customer appointments listed in chronological order, with the specific charges usually entered by customer's name.

**BOOTH RENTER** -- An individual that leases a specific area in a salon.

**CLIENTELE** -- A body of customers or patrons.

**COSMETICS** -- Serving to beautify the body.

**COSMETOLOGY** -- The study or art of cosmetics.

**CUSTOMER CARDS** - A record maintained on services rendered to a client.

**RENTAL REVENUE** - Source of income from leasing a specific area in a salon.

**RETAIL REVENUE** - Source of income from products or supplies sold.

**SALON** - A commercial establishment offering a product or service related to fashion.

**SERVICE REVENUE** - Source of income from providing a service to a client.

**STATE BOARD OF COSMETOLOGY** - A state regulatory agency.

**STATION, WORKSTATION, BOOTH** - A work area used by an individual in a salon.

**STRICT CHAIR LEASE, CHAIR LEASE** - An arrangement with a salon owner and an individual that grants use or occupancy of a location for a certain length of time.

**STYLIST** - A consultant on beauty.

**TIPS** - A sum of money given as acknowledgement of service rendered; gratuity.

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## INDUSTRY SOURCES

1. Cosmetology Business America (CBA Journal)

A journal devoted to raising the awareness of the Cosmetology industry to basic business practices.

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