



Market Segment Specialization Program



Pizza Restaurant

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.



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INTRODUCTION

A project was conducted by the Providence District on the pizza industry. Because pizza restaurants are basically cash businesses, the potential for skimming exists. The type of entities discussed in this guide are the family owned mom and pop types of establishments. The "chain" or "franchise" types of pizza parlors are not addressed in this guide due to the nature of their operations, that is, the close control maintained by the franchise of these establishments does not lend itself to the approaches discussed in this guide.

Overall, documentation of income and expenses in this industry has been found to be lacking. In most instances, the cash register tapes are not retained and income is not deposited intact. There is generally little or no documentation to verify the gross receipts reported on the tax return. Purchases are often paid in cash and the purchase invoices are not kept. Employees are often paid in cash, sometimes, in order to avoid the payroll taxes.

The Providence district used the unit volume markup computation to attempt to overcome these obstacles. The project group found that it was necessary to contact the pizza restaurant suppliers to obtain the original purchase invoices on all identified cases. The ingredients purchased and used in the making of pizzas and grinders were used to determine total pizza and grinder sales.

Anyone considering the use of this technique should contact their District Counsel prior to initiating any action in order to get Counsel's opinion on using this approach. In any of these examinations, an attempt should also be made to use a conventional indirect method such as a bank deposit analysis, net worth computation, source and application, etc. to corroborate the amount of the understatement. The most critical aspects to the success in this approach is the ability to document purchases and conduct a detailed interview with the owner of the business.

If feasible, use of a project coordinator will limit the examiners' time on the cases. The coordinator will be responsible for coordinating and overseeing the entire project. Securing all third party invoices and obtaining the laboratory testing results can be done by the coordinator. The specifics on the audit

procedures are discussed in more detail in later sections.

Note: The term "grinder" is used throughout this audit guide. The term grinder refers to the type of sandwiches which are sold by pizza restaurants in the Providence District. Grinders may be referred to as "submarines" or "hoagies" in other locations.

Chapter 1

THE PIZZA INDUSTRY - SKIMMING, CASH PAYROLL, CASH PURCHASES

It has been suggested that skimming may be common in the pizza industry. The Providence District's examinations support a finding that skimming of receipts and understatement of purchases in the pizza industry is not unusual. The task is to identify and examine those pizza establishments in which skimming takes place to achieve greater compliance in the industry.

Information obtained from various sources in Providence strongly indicate that the practice of paying employees "off the books" is common in pizza restaurants. Moreover, purchases are often paid in cash with no invoices or receipts to document the expenses.

By obtaining supplier invoices and compiling the quantity of ingredients purchased for the pizza and grinder items, the number of pizza and grinder sales can be redetermined. Flour, sauce cheese, and grinder meats are all used in the computation. In addition, the total amount of pizza boxes and grinder rolls can be used to support the computation.

Some pizza restaurants may be difficult to audit. Almost all of the restaurants encountered by the project group were closely held entities with basically no internal control over cash. The group also found the pizza restaurant owners to be a tight knit community. Information such as what questions and what techniques the Service is using in audits would be quickly communicated through out the community.

In addition, the books and records maintained by many of these pizza restaurants are not detailed or complete. Cash receipts book often consists of a sheet of paper with a summary of 12 months sales. Many times, the preparer uses the sales reported on the 12 sales tax returns, with no other backup. The restaurant usually keeps the cash register tapes long enough to determine if the employees are stealing, then the tapes are destroyed.

Examinations have also revealed that several taxpayers took cash out of the drawer without reporting the amount as income. There is virtually no audit trail to determine the amount of funds spent for business and personal expenses. When it is time to make a deposit, some taxpayers would pocket some of the cash and

deposit only that portion necessary to cover those expenses to be paid by check. It was found in many cases that business expenses **as well as personal living expenses** were paid with cash taken from the cash drawer. Audits in Providence have uncovered as much as \$700 per week in cash being taken out of the cash drawer.

Furthermore, the project group also found that many pizza restaurant owners are aware of the Government's need to establish certain facts to fully develop the unreported income issue. Most of the individuals encountered by the project group appeared to live modestly with no apparent great accumulation of assets. Therefore, examiners should be alert to look beyond this to develop the underreporting income issue.

Chapter 2

SELECTION OF PIZZA RESTAURANTS FOR EXAMINATION

The starting point is to identify all pizza restaurants in your area. This can be done by using the telephone yellow pages. However, this can be a time consuming task. If there are quite a few pizza establishments in the area, it may be necessary to use a service that provides this type of information.

American Business Lists Inc., is a company which compiles a list of all businesses by industry. **American Business Lists** will provide a list of all pizza restaurants in your specific area. The listing not only indicates the restaurants by location, but more importantly indicates the owner of the business.

A catalog can be obtained by calling or writing:

American Business Lists
5711 South 86th Circle
P.O. Box 27347
Omaha, Nebraska 68127
(402) 331-7169
FAX (402) 331-1505

Once the pizza establishments and their owners have been determined, the next step is to use IDRS to secure the EIN of the businesses and the SSN for the individual owners. Secure a transcript of the account and whenever possible request a RTVUE for each return. This is the first attempt in eliminating those returns that reflect little or no audit potential. Obviously, you want to secure those returns which show the greatest audit potential. The actual securing of the original returns can be accomplished by working jointly with the Planning and Special Programs Chief in the District. When the list of returns is prepared, the Chief-PSP can expeditiously requisition the returns using special project codes.

The original tax returns should be screened. In the Providence District, the initial screening process was undertaken by comparing gross receipts to purchases. Also considered were factors such as adjusted gross income relative to taxpayer's family size, large increases in interest income, very low or no net profit, location of the pizza parlors, that is, neighborhood characteristics and seasonable variations, and any other classification techniques to identify the

cases with the best audit potential. Additionally, it is important to secure and screen the shareholder's returns for each targeted corporation for potential indications of unreported income.

Once the targeted cases were identified, these cases were separated into several examination phases. By using several staggered phases, the project was more manageable and easier to monitor.

Because the Providence District covers a small geographical area, canvas letters were sent to all known pizza restaurant suppliers in the R.I. area. See Exhibit 2-1. This information was very helpful in the screening process. If the purchases amount per the third party suppliers exceeded the purchases claimed on the tax return, there was an apparent problem that warranted explanation. In addition, there were situations where the owner destroyed all of the purchase invoices for a particular supplier and did not claim a deduction for purchases from that supplier. By canvassing all of the known suppliers in the area, these situations were discovered. This scheme probably would not have been detected without contacting all of the suppliers.

Obviously, the geographical size of the district will dictate the feasibility of sending this letter. It may be impossible to canvass all suppliers in the larger districts. Therefore it may be more practical to obtain a list of suppliers from each agent so only those suppliers will be contacted.

Exhibit 2-1 (1 of 2)

Internal Revenue Service
District Director

Department of Treasury

Person to Contact

Telephone Number:

Refer Reply to:

Date:

The _____ District is now beginning Phase _____ of the Pizza Project. We have now identified approximately _____ pizza restaurants that we are interested for this phase of the project.

Information is requested relative to the total amount of sales made by you to the attached list of establishments. Your help in connection with an official investigation concerning these taxpayers would be appreciated.

Please enter on the attached worksheet the total sales made to each establishment for the years indicated. If no sales were made to the establishment, please enter a "-0-" next to the name of this business.

A Self-addressed envelope is enclosed for your convenience. Please return the enclosed worksheet by _____. If you cannot meet this deadline, please notify me as soon as possible and the necessary arrangements can be made. Failure to respond will result in the immediate issuance of a summons. You should direct any inquiry to Revenue Agent _____.

We are making this request under the authority of Section 7602 and 7609 of the Internal Revenue Code. The information you furnish will be held in strict confidence.

Thank you for your assistance in this inquiry and if you have any questions, please feel free to contact me.

Very truly yours,

REVENUE AGENT

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Exhibit 2-1 (2 of 2)

Establishment Name and Address	1990	1991	1992	1993

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Chapter 3

PREAUDIT

Exhibit 3-1 is a copy of the suggested Initial Pizza Restaurant Information Document Request. It is very important to request this information prior to the initial interview.

The Initial Pizza Restaurant IDR appears to be lengthy and can seem to be intimidating, but it is necessary that this information be obtained early. Requesting this information prior to your first visit will make for a faster and more efficient audit. It is important that the books and records used to prepare the tax return are available at the first meeting. The purchase invoices should also be available so they can be fully analyzed. Make sure that the taxpayer has a menu available at this meeting so that the menu prices can be clearly determined. These prices will prove to be important later in the examination.

It is crucial to analyze the business and personal bank accounts, tracing all the nontaxable sources of income. It is important that a detailed analysis be performed during the initial stages of the examination. An accurate and complete initial IDR will expedite the examination and provide for a more thorough initial interview.

The examining agent's preaudit should consider the following steps:

1. Cash T at the owner/shareholder level.
2. Use of other available sources to verify income such as Forms 8300, TECS inquiry, IRP's, and CID information items.
3. Use of public record sources such as city and town halls, Registry of Motor Vehicles, Secretary of State, and Business Cumulative Index (B.C.I.).
4. Emphasis should be on sales/income, cost of goods sold and inventory.
5. Payroll expense and only large and extraordinary expenses should be identified.
6. Request copies of all related and subsequent returns not included in the package.

7. When requesting IRP documents, request current and subsequent years.
8. Whenever possible, contact the State Division of Taxation for any state sales/income tax examination reports.

Obviously, it is very important to be as prepared as possible for the initial interview.

INITIAL PIZZA RESTAURANT
INFORMATION DOCUMENT REQUEST

DOCUMENTS REQUESTED

Please have the following documents ready for our initial appointment.

1. A copy of tax returns for the years 19__ and 19__.
2. A copy of related returns.
3. A copy of the payroll tax returns (four Forms 941 and one Form 940) for the year 19__.
4. Current year Forms W-2 and Forms W-4. A copy of the Forms 1099 issued for 19__.
5. Workpapers of schedules used in preparing the tax return.
6. Books and tax records relating to your income, expenses, and deductions.

-- A copy of the income portion of your books and records for the year(s) under examination.
7. All purchase invoices.
 - a. Attempt to have the invoices separated by vendor.
 - b. Request a listing of all cash expenses.

8. For business and personal bank accounts, brokerage and money market accounts, provide statements, cancelled checks, deposit slips and check registers for the period December 19__ through January 19__.
 - a. Please take the bank statements out of the envelopes, and arrange them in chronological order. Separate the statements from the cancelled checks.
 - b. List transfers between bank, brokerage and money market accounts. Document all transfers.
9. Documents concerning loans and loan repayments if they occurred in the year(s) under examination.
10. Information on all nontaxable income (for example, gifts, interest on municipal bond, inheritance, etc.)
11. Documents concerning the purchase, sale or exchange of real estate or personal property for 19__.
12. Personal living expense statement completed for 19__.
 - a. Please distinguish between expenses paid by cash versus check.
 - b. Credit card statements for the year(s) under audit.
13. A list of business expenses paid by cash for the year(s) under audit.
14. Documentation concerning business capital expenditures, such as pizza ovens, equipment etc. made during the year under audit.
15. A menu showing all items sold at the pizza restaurant. (Copy of the current menu as well as the menu used during the year under audit.)

Chapter 4

INITIAL INTERVIEW

The initial interview is very important in these cases because of the lack of an audit trail and the poor recordkeeping. It should be stressed that accurate documentation of the initial interview is critical.

Use the Pizza Questionnaire to establish how the pizza restaurant is operated. (See Exhibit 4-1.) These questions are important and should be covered during the initial interview or as early in the examination as possible. These questions will give the examining agent an overview of the pizza restaurant's day to day activities. When using the list of suggested questions, keep in mind that while the list is not all inclusive, at the same time, not all questions would be appropriate to ask in all cases. The examiner should only ask those questions that are relevant and necessary to properly develop his or her case.

A contemporaneous record of the questions and answers should be made during the initial interview to establish the facts. Therefore, during the initial interview, the agent should ask the taxpayer to verify the accuracy of the information and not wait until the audit is near completion. The contemporaneous notes from the initial interview can be relied on in the resolution phase of the case, when the agent and the taxpayer are clarifying the income issue and related factual discrepancies. The answers to many of these questions are critical later in the examination, when the ingredients markup computation is prepared.

Request that the taxpayer (owner/operator) be present at the initial interview. This is important because there are questions that only the pizza restaurant owner can answer. If there is a power of attorney filed, it should be stressed that the taxpayer be present for the initial interview because most questions can only be answered by the person responsible for day-to-day operations. Experience shows that most representatives do not have first hand knowledge about the actual operation of the restaurant.

At the initial interview, obtain a copy of the menu and review the prices of all menu items with the taxpayer. Identify the big selling items. If it is impossible to get a menu for the tax year under examination, review a current menu with the owner to determine price changes and fluctuations between current and old menus. Make

the appropriate notes and clarify any discrepancies because the selling prices are critical to the unit volume markup computation. When there are no old menus available, contact the company that printed the menu. Often, the printer keeps copies of the old menus.

Review the Statement of Annual Estimated Personal and Family Expense (Form 4822) with the taxpayer at the initial interview. Be sure that the taxpayer clearly understands the form and completes it properly to avoid the argument that the taxpayer did not fully understand the form. Determine exactly what expenses were paid with cash and which were paid by check. Attempt to determine at this point exactly how much cash the owner takes from the cash drawer to pay personal expenses.

Prepare a detailed listing of purchase invoices determining how they were paid, cash or check. Account for the possibility of missing invoices. Review suppliers with the pizza shop owner, and determine what products are purchased from the various suppliers. This may appear to be a time consuming task, but agents have discovered many good issues through this technique. The following scenarios illustrate this point:

1. The examiner questioned the owner about his suppliers and noted that there were no deductions for soda purchases. The taxpayer stated he had nothing to do with the soda machine. By contacting the soda supplier, it was determined that taxpayer had made soda purchases and had not reported income from the soda sales.
2. The examiner noticed that certain ingredients were not reflected on the purchase invoices. In addition, there were missing invoices. From the original invoices received from the supplier, it was determined that the owner understated purchases by over \$ 50,000. This was done to camouflage the skimming by keeping the gross profit percentage in line.

The pizza boxes will be a factor in the unit volume markup computation. Establish where the owner is purchasing pizza boxes. Also, confirm where the taxpayer purchases grinder rolls. Ask the owner approximately how many grinder rolls are delivered each day because the restaurants receive relatively standard orders daily. Some taxpayers have used the defense that they return day old bread to the bakery. The bulk of the bakeries in Providence area stated that this is not the case because the markup is so low on the rolls. (This should be verified in each district if grinder

rolls are going to be used as a factor for income reconstruction.) The bakers state that they would be out of business if this was the practice. Attempt to tie down the amount of grinder rolls purchased during the early stages of the examination. The grinder rolls purchases will be used to confirm the reconstructed grinder sales calculated using the ingredient markup method.

Another thing that should be done is to tie down exactly how many pizzas can be made out of 100 pounds of flour. Determine during the initial interview exactly what pizza ingredients the owner throws away due to spoilage. If the owner insists that there is a spoilage factor, question him/her about each ingredient during the early phase of the audit and agree on the amount of spoilage. Have the owner walk you through the complete pizza making process. If the owner makes dough balls, determine how many dough balls are made each day. Get the specifics as to exactly how much spoilage there actually is and why the product could not be sold. The suppliers have indicated that there is very little spoilage with flour. Generally, flour deliveries are pretty much standard orders in the pizza business. The owner knows exactly how much flour is needed to make the dough for the day-to-day pizza orders. Damaged bags of flour may be easily replaced by the supplier.

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QUESTIONNAIRE

THE FOLLOWING IS AN OUTLINE OF SUGGESTED QUESTIONS FOR THE INITIAL INTERVIEW OF PIZZA RESTAURANT OWNERS. (**Note:** While the list is not all inclusive, at the same time, not all questions listed are warranted in every case. Examiners should use the following as a guide, and ask only those questions that are appropriate for their specific case.)

HISTORY:

1. Where is the taxpayer from?
2. How long has the taxpayer been in business?
3. How did the taxpayer get started in the business?
4. Where did taxpayer get capital to start business?
5. Who did the taxpayer purchase the business from?
When? Cost?
Obtain a copy of the sales agreement.
6. Exactly what assets were purchased? Goodwill?
7. Do relatives work in the restaurant?
If yes, obtain names and relationship to taxpayer.
8. Does the taxpayer own or rent the restaurant space?
9. Does the restaurant owner own his/her own home?
10. How much are the rent/mortgage payments:
 - a. For the restaurant?
 - b. For the home?

11. Does the taxpayer own any other businesses?
12. What type of records are available?
13. Are there separate bank accounts for business and personal?
 - Identify all accounts.
14. Who keeps the books and records?
15. What information is sent to the accountant?
16. Does the taxpayer have control over any foreign bank accounts? If so, where?
17. Does the taxpayer own property outside the United States? If so, where?

BUSINESS ACTIVITIES

1. Ask the taxpayer to describe the business:
 - a. Number of days a week open?
 - b. Hours open?
 - c. Does the restaurant close for vacation?
 - d. Who works & how many employees?
 - e. What are the responsibilities of each employee?
 - f. Does the taxpayer pay the employees in cash?
 - g. Percentage of takeout versus eat in business?
 - h. Pizza sales versus grinder sales?
 - i. Are there good/bad times during the year? When?

2. Are all receipts deposited and to which account?
3. Are cash register tapes used and maintained?
4. Does the taxpayer sell beer or wine?
5. Does the taxpayer sell soda in cans or through machines using syrup and water?
6. What are good and bad selling items on the menu?
7. By going down through the menu carefully, question the taxpayer about ingredients and the amounts used in the preparation of each item on the menu?

a. Pizza

- 1) Ask about the sizes of the pizzas sold.
- 2) What type of cheese is used on the pizzas?
- 3) What pizza ingredients does the taxpayer throw away due to spoilage? If spoilage is claimed, what ingredients and how much?
- 4) Why couldn't the product be sold?
- 5) Approximately how many pizzas can be made out of 100 pounds of flour?
- 6) How many dough balls are made each day?

b. Grinders

- 1) Where does the taxpayer purchase grinder rolls?
- 2) How many grinder rolls are delivered each day?
- 3) What are the sizes and types?
- 4) What ingredients are subject to spoilage and the percentage?

- 5) Which grinders sell the best?
- 6) What goes into the grinders? (Amounts/ozs.)
- 7) What sizes are used for rolls? (be sure to ask if the taxpayer is buying larger rolls and cutting them down for sandwiches or buying the small rolls.)

c. Drinks

- 1) Ask about the sizes of the drink cups.
 - 2) Which size is sold the most? (Small, medium, large.)
8. Who are the suppliers of the ingredients?
 9. Ask the taxpayer what products are purchased from the various suppliers?
 10. Does the owner call suppliers or do they contact him/her?
 11. Where does the taxpayer purchase the pizza boxes?
 12. Does the taxpayer make purchases in cash? If so, how are these accounted for?
 13. Does the taxpayer take cash out from the register to pay expenses?
 - If so, what are those expenses and how are they accounted for?
 14. Question taxpayer about their video vending machine income:
 - a. Who does the taxpayer rent their machines from?
 - b. Does the taxpayer own any machines?
 15. Are there any cigarette machines?

Chapter 5

EXAMINATION TECHNIQUES

In general, the examination of a pizza restaurant tax return is not much different than other examinations. The examiner will often find little or no internal control. Many times, there would be few records available, and sometimes no records at all. Before the alternative method is used, you first need to establish the inadequacy of the taxpayer's books and records. This would necessitate the issuance of an inadequate records notice.

It is not uncommon for the pizza restaurant owners to regularly pay expenses with cash. This often results in little or no paper trail. Invoices are often not retained requiring the need to obtain third party supplier invoices. Some owners have indicated that they do not deposit the daily gross receipts intact. Some owners even have acknowledged taking cash from the cash register to pay personal expenses.

It is crucial that the agent perform a detailed analysis of gross income and purchases to show that the records are unreliable. It is important to show that a material item on the tax return is incorrect and therefore, an indirect method of proving income should be used. The following situations are indications of poor sales records.

1. Gross receipts on the tax return come from monthly summary sheets. The amounts are all even, round amounts with no further backup.
2. Gross receipts per return come from monthly sales tax returns filed with the state. The sales tax returns are the only records of gross receipts.
3. Taxpayer computed receipts based on deposits to the bank accounts, yet failed to report the deposits made to personal accounts and cash payouts.
4. Taxpayer has absolutely no documentation to support the income reported on the tax return.

These are all examples of the poor records furnished to examining agents. Document the reasons why the method used by the taxpayer to determine income is unreliable, requiring the use of an alternative method. An inadequate records notice should be considered in all circumstances where the records are deemed inadequate.

See the chapter on inadequate records notices.

In addition to gross receipts, agents should concentrate on the cost of sales section, identifying the suppliers of the pizza and grinder ingredients.

The project coordinator, or if there is no project coordinator, the agent can then contact the third party suppliers and obtain the original invoices. The original invoices will then be used as the source documents for the unit volume markup computation.

More importantly, the agent should look for the following:

1. Personal living expenses well above reported income
2. Assets acquired possibly with skimmed receipts
3. Accumulation of funds in various bank accounts with no reported income
4. A low gross profit percentage
5. Assets such as automobiles, personal residence, etc., could be indications of unreported income
6. Other lavish expenses with no nontaxable source of income.

Chapter 6

CONFIRMATION OF PURCHASES

Each examiner is responsible for identifying the individual suppliers for the purchases claimed on the tax return. Using a supplier feedback sheet similar to Exhibit 6-1, the agent will summarize the purchases claimed on the tax return by the supplier. This information will then be compared with the actual third party supplier confirmation amounts. The project coordinator or agent will be responsible for contacting the vendors to confirm purchases.

The agent will either secure taxpayer copies of the purchase invoices or photocopy them, but only if a determination can be made that the invoices can be relied on. If there are no taxpayer invoices available or a large portion of the invoices are missing, the project coordinator or agent should secure the original invoices from each third party vendor.

To confirm purchases, a summons may be used. One summons can be issued to each supplier to cover all cases in the project. This is much more practical than having several agents contacting the same supplier.

The original invoices are crucial in the preparation of the ingredient markup computation. The ingredients used in the making of the pizzas and grinders will be input from these original invoices. When the agent determines that the records are poor and the purchase deduction on the tax return is incorrect, consideration should be given to securing the third party invoices as soon as possible for use in the unit volume markup computation.

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SUPPLIER FEEDBACK SHEET

PIZZA ESTABLISHMENT _____	AGENT _____	
	19__*	19__*
TOTAL PURCHASES PER RETURN	_____	_____
TOTAL GROSS RECEIPTS PER RETURN	_____	_____
INDIVIDUAL SUPPLIER AMOUNTS (SUPPLIER NAME)		
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
TOTAL PURCHASES	=====	=====

DOES THE TAXPAYER HAVE ANY PURCHASE INVOICES? YES () NO ()

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Chapter 7

OVERVIEW OF THE INGREDIENT MARKUP COMPUTATION

The ingredient markup computation is an indirect method used to reconstruct the gross receipts of the pizza restaurants. It is important to stress that this method is not intended to be used on all cases but rather should be considered once it has been determined that the taxpayer's financial books and records cannot be relied on.

Treas. Reg. section 1.446 authorizes the IRS to compute income in accordance with whatever method that clearly reflects income, where the taxpayer keeps no records, or the financial records are inadequate and unreliable. The percentage or unit volume method has been considered an acceptable method of proving income in Tax Court. In addition, the Tax Court has allowed the use of third party supplier records in ascertaining the cost of goods and the gross profit resulting from business activities where the records are inadequate.

In *Maltese v. Commissioner*, T.C. Memo. 1988-322, the Tax Court ruled in favor of the Internal Revenue Service, where the taxpayer failed to keep adequate records for the pizza restaurant's sales, cost of sales, and expenses. Not all of the restaurant's receipts were deposited and some of the expenses were paid in cash. The court held for the Service where the IRS used supplier information to reconstruct the income. The IRS determined corrected gross receipts from the estimated number of pizzas which could be made from the amount of flour purchased during the years in question.

Although the court held for the Service, it criticized the failure to compare the pizzas sold by the taxpayer with those sold by retail chains that provided the information on which the reconstruction was based. Accordingly, use of this method must be supported by careful documentation of the quantity of flour the taxpayer would need to produce a given number of pizzas.

Using this theory, the supplier invoices were obtained for all pizza restaurant cases where the taxpayer's financial records were poor or the records did not exist. The total amount of flour, sauce and cheese purchases were determined and used in the computation. Also the supplier invoices were obtained for the

grinder meats being purchased so that total grinder sales could also be estimated.

An additional step was taken in the project group's ingredient markup computation. A large and a small pizza were purchased from the restaurant and sent to a food testing laboratory to be weighed and analyzed. The laboratory was able to establish the total weight of the flour, sauce and cheese that went into each pizza for each restaurant. Various large and small grinders listed on the menu were also purchased and analyzed at the laboratory. The lab was also able to furnish the total weight of the meats in each grinder.

Gross receipts were reconstructed from the estimated number of pizzas and grinders which could be made from the ingredients purchased. The reconstruction of gross receipts also included soda and beer sales. Based on the information obtained from the beverage distributors, the total beer and soda sales could be calculated.

Remember, this computation considers grinders and pizza sales only. This calculation does not take into consideration other types of meals such as spaghetti dinners, fish and chips, salads, and any other dinners. These additional dinners would only serve to increase the reconstructed gross receipts. For this reason, the ingredients markup computation is a very conservative approach in the reconstruction of the gross receipts. This point should be stressed in defending this computation because gross receipts could be much higher if the dinners were considered.

The project group found these assumptions to be valid in the Providence District, and believe they may be valid in other districts as well. To properly develop your case, however, you will need to establish and document their validity in your area and with the particular restaurant under examination.

It is recommended that the examiner consider a traditional indirect method to further substantiate the ingredient markup computation. Consideration should be given to using the bank deposits, net worth or some other indirect method to prove that the taxpayer is skimming the cash and the disposition of these funds. This will be discussed further in Chapter 11.

Chapter 8

PIZZA AND GRINDER LABORATORY TESTING

SHOPPING PHASE

The next step in the process is to actually purchase the pizzas and grinders and have the samples tested at the food testing laboratory. Contact the food analysis laboratories listed in your local telephone yellow pages. These laboratories will actually do the necessary testing to establish the actual weight of the ingredients in each sample.

The "shopping phase" is quite simple. A large and a small plain cheese pizza should be purchased. For testing purposes, the laboratory prefers that the pizza be slightly cooked, therefore ask for the pizza partially cooked. The laboratory will be able to separate and weigh the flour, sauce and cheese for that pizza. There is a heating test done on the crust of the pizza to determine the dry weight of the dough. This is the actual weight of the flour used in the process.

A small and large plain cheese pizza must be purchased and tested so that the "average weight" can be used in the unit volume computation. The average weight is used to avoid the argument that more large pizzas than small or vice versa are sold.

The same should be done for each grinder listed on the menu. A small and large grinder should be purchased and sent to the laboratory for testing. The laboratory will determine the actual weight of all the meats in the grinder.

Certain additional factors should be considered.

1. Purchase a large and small plain cheese pizza. Do not purchase any toppings on the pizza. This again is a conservative approach because toppings would only increase the selling price of the pizza.
2. Purchase the grinders with no oils, mayonnaise, mustard, melted cheese or any other items which could affect the weight of the grinder meats.
3. Once the samples are purchased, **they must be delivered to the laboratory the same day.**

4. Maintain an accurate inventory of the samples tested.
5. The custody and control of the samples is critical. The Providence District used a custody control sheet for all food samples delivered to the lab (See Exhibit 8-1). Record on the control sheet the following information: the type of sample purchased, the date and time of the purchase and the date and time the sample was delivered to the laboratory. Have an official from the laboratory sign the custody sheet.

LABORATORY TESTING

The laboratory will test each sample and determine the actual weight of the flour, sauce and cheese in each pizza. The weight of each type of grinder ingredient will also be calculated by the laboratory. The Providence District used **Microbac Laboratories** for their testing.

Microbac Laboratories can be contacted at:

**Microbac Laboratories Inc.
202 Bussey Street
Dedham, Massachusetts 02026
617 326-7117**

The **Microbac Laboratory** listed above is the New England subsidiary. (See Exhibit 8-2 for other **Microbac Laboratories** located elsewhere in the country. Please note that Microbac is just one of many laboratories that can provide food analysis services. Consult your telephone directory to locate the most convenient one.)

The laboratory will summarize the test results in a report form. The report will tell you the weight of each of the main ingredients of the samples submitted. For example, for a pizza, the report will show the weight of the entire pizza, the weight of the cheese, the weight of the sauce, the weight of the crust, the percentage of solids and the weight of dry ingredients such as flour. For each individual sandwich sample, the report will show the size of the bun (in inches), weight of the bun, the weight of the meat, and the weight of the cheese.

CUSTODY CONTROL SHEET

SAMPLE NUMBER: _____

ITEM PURCHASED: _____

DATE SAMPLE PURCHASED: _____

TIME SAMPLE PURCHASED: _____

LOCATION OF PURCHASE: _____

AGENT PURCHASING THE SAMPLE: _____

DATE TRANSPORTED TO _____ LABORATORIES: _____

TIME DELIVERED TO LABORATORY: _____

TEMPERATURE DURING TRANSPORTATION TO LAB: _____

RECEIVED BY _____ LABORATORIES:

DATE:

TIME:

SIGNATURE:

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LISTING OF MICROBAC LABORATORIES

MICROBAC LABORATORIES, INC.
Home Office & Laboratory
4580 McKnight Road
Pittsburgh, PA 15237
(412) 931-5851

SCHILLER LABORATORY DIVISION
449 Rochester Road
Pittsburgh, PA 15237
(412) 369-1830

ERIE TESTING LABORATORY
2411 West 26th Street
Erie, PA 16506
(814) 833-4790

NEW CASTLE LABORATORY
R.D. #3
Pulaski Road
New Castle, PA 16105
(412) 654-4212

KENTUCKY TESTING LABORATORY
1121 West Broadway
Louisville, KY 40203
(502) 583-5256

MASSACHUSETTS TESTING LABORATORY
202 Bussey Street
Dedham, MA 02026
(617) 326-7117

MICROBAC HANOVER DIVISION
701 Third Street
Hanover, PA 17331
(717) 633-6011

JOHNSTOWN LABORATORY DIVISION
P.O. BOX 1447
JOHNSTOWN, PA 15907-0447
(814) 266-9548

SEAWAY LABORATORY DIVISION
542-544 Conkey Street
Hammond, IN 46324
(219) 932-1770

MICROBAC ENVIRONMENTAL LABORATORY
P. O. Box 49
Fayetteville, NC 28301
(919) 864-1920

MICROBAC MID-ATLANTIC INC
12650 McManus Blvd.
Suite 4
Newport News, VA 23602
(804) 874-4930

SENATE ANALYTICAL LABORATORY DIVISION
U-Parc
545 William Pitt Way
Pittsburgh, PA 15238
(412) 826-3700

J-LABS Inc.
P. O. Box 489
Bradford, PA 16701
(814) 368-6087

TAYLOR-MILK COMPANY
348 Merchant Street
P. O. Box D
Ambridge, PA 15003
(412) 266-9334

MICROBAC INGOMAR DIVISION
P.O. Box 368
Harmony Drive
Ingomar, PA 15127
(412) 364-4820

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Chapter 9

COMPUTATION OF GRINDER AND PIZZA SALES

As discussed earlier, the total number of pizzas and grinders sold can be determined from the amount of ingredients purchased, and the restaurants income can, therefore, be reconstructed.

The following explains the steps in the reconstruction of pizza and grinder income.

PIZZA

1. Determine the total number of pounds of flour and cheese purchased and the number of cans of pizza sauce purchased.
2. Multiply the total number of pounds of flour and cheese by 16 to calculate the total number of ounces of flour and cheese, respectively.
3. Multiply the total number of cans of pizza sauce by 105 ounces (the total number of ounces in a #10 size can).
4. Divide the total ounces of flour, sauce and cheese purchased by the respective average weight of each ingredient per laboratory results.
5. The result is the total estimated number of pizzas sold based on flour, cheese or sauce purchased. The three methods (flour, cheese or sauce) should closely approximate pizza sales and should be relatively close. Attempt to use the lower, more conservative number of pizzas sold. If there is a large discrepancy between the three methods, there is a chance that not all of the suppliers have been identified, or possibly some products were purchased with cash.
6. Multiply the units sold by the average menu price of a large and small cheese pizza to arrive at pizza sales.

Example 1

Assume that the purchases for flour, cheese, and sauce were 12,000 lbs., 9,000 lbs., and 800 cans (#10 size), respectively. Also,

laboratory testing of one large and one small pizza found the average weight of the flour, cheese and sauce were 9.5, 7, and 4 ounces respectively. The average menu price for pizza is \$6.

	<u>Flour</u> 12,000	<u>Cheese</u> 9,000	<u>Sauce</u> 800
<u>Purchases</u> Converted to ounces	x 16	x 16	x 105
Total Ounces	192,000	144,000	84,000
Divide by Average Weight	<u>9.5</u>	<u>7</u>	<u>4</u>
Total Units Sold	20,210	20,571	21,000

Since the discrepancy here is not substantial, continue with steps 5 and 6.

Take the lowest of the three results, in this case the amount is 20,210 units, and multiply the total units sold by the average menu price for pizza.

Total Estimated Pizza Sales =

$$20,210 \text{ units} \times \$6 = \$121,260$$

=====

GRINDER

The following steps should be performed on each type of grinder.

1. Determine the total amount of the grinder meat purchased.
2. Meat purchases are normally stated in pounds. Convert to ounces by multiplying the number of pounds by 16.
3. Obtain the average weight of the large and small grinder determined by the food testing laboratory. Divide the total ounces of meat purchased by the average calculated weight of each sample to arrive at the number of grinders sold.
4. Multiply the total number of grinders sold by the average menu price. The average menu price is the average price of the small size and the large size grinders.

- The result is the estimated amount of income for that type grinder.

Example 2

Assume 500 pounds of roast beef was purchased. Laboratory testing show the average weight of the meat in a grinder is 5 ounces. The average menu price for a roast beef grinder is \$4.

Meat Purchased	500 lbs.
Convert to ounces	x 16

Meat in ounces	8,000
Divide by Average weight	5

Grinder sold in units	1,600
Average menu price	x 4

Roast Beef Grinder Sales	\$ 6,400
	=====

ADDITIONAL CONSIDERATIONS

- If a supplier accepts cash for the purchases and the slip is made out to cash, there is no way the third party can identify who made the purchase. Those ingredients may have an impact on the computation. It is very common in this industry that if you pay with cash, then you get a better price. If the taxpayer does purchase items with cash, keep this in mind. Secure the taxpayers copies of the cash invoices so that these ingredients can be considered in the computation.
- SPOILAGE** - Generally, a reasonable spoilage factor should be allowed (a 10 percent spoilage factor was allowed by Providence). Attempt to determine a spoilage factor during your discussions with the owner.
- PRICING** - Use the menu price for the year under examination. Compute the average price of a large and a small item. In the event that an old menu can not be obtained, use a current menu. Discuss the price fluctuations between the old and new prices with the restaurant owner to come up with an inflation factor to back into the old menu prices (Providence had allowed a 6 percent price

adjustment in their project). For pizza prices, use the lowest priced plain cheese pizza in the computation. The toppings on the pizzas are not considered. If the taxpayer argues that the toppings should be considered, this will only serve to increase the income computation. There is less meat used as a topping on the pizza than if the meat is used in the grinder. Some pizza restaurants charge as much as a dollar more for each pizza topping added. Therefore, the more conservative approach is to consider the meat as used in the grinders as opposed to a pizza topping. (Each pizza restaurant should be asked which produces the higher mark-up meat pizzas or grinders.)

4. Use the box computation and compare the number of boxes purchased to the number of pizzas sold. The pizza boxes purchased should support the recomputed pizza sales. The eat in versus takeout ratio determined in the initial interview should also be considered.
5. Use the grinder rolls calculation to support the recomputed total grinder sales.

Remember, the raw ingredient markup calculation may not be warranted in every case. Evaluate the internal control of the restaurant. Evaluate the books and records used in the preparation of the tax return. Evaluate the taxpayer's financial status in relation to the reported income. Consideration should be given to use of this method where there is a strong possibility of skimmed income, or if the taxpayer maintains no records and the purchase invoices are not available or if no tax returns were filed. Most of all, use this method in conjunction with the more conventional indirect methods to determine the amount of the skimmed income and the disposition of the skimmed income.

Chapter 10

BEVERAGE COMPUTATION

CANS/BOTTLES OF SODA AND BEER

The beverage suppliers will confirm the total units of soda and beer purchased. Generally, the products are purchased by the case, 24 units per case. Determine the selling price of the soda and beer. Next, project the total sales of soda and beer by multiplying the number of cans purchased by the unit selling price.

PREMIX SODA

Premix soda is purchased by the tank. Each tank contains 5 gallons of syrup. The ratio of soda water to syrup is 5 to 1.

The following computation is necessary to establish the number of servings per tank of syrup.

1.
$$\begin{array}{r} 1 \text{ tank} = 5 \text{ gallons of syrup} \\ 5 \text{ tanks} = 25 \text{ gallons of soda water} \\ \hline 30 \text{ gallons of product} \end{array}$$
2. $128 \text{ oz. / gal} \times 30 \text{ gallons} = 3,840 \text{ ounces}$
3. If the establishment's average cup size is 12 ounces, the quantity actually dispensed will be 10 ounces per serving. (The examining agent must be careful to document the basis for this assumption.)
$$3,840 \text{ ounces divided by } 10 \text{ ounces} = 384 \text{ servings per tank}$$

When considering this computation, remember to consider ice and waste using a conservative approach in the calculation.

DRAFT BEER - CALCULATION FOR KEGS

Draft beer is sold by the one quarter keg and one half keg. A one quarter keg contains 992 ounces of beer. A one half keg contains 1,984 ounces of beer. The beer distributors calculate that there are approximately 190 glass servings per one half keg and 93 servings from a one quarter keg. This accounts for the foam and spillage which is common with draft beer. (This may

depend on local practice and needs to be documented by the examining agent.)

Remember, only beer and soda sales are considered in the beverage computation. If the establishment sells wine, liquor, juices or coffee, this would only serve to increase the beverage sales.

Chapter 11

SECOND METHOD OF DETERMINING INCOME/PROOF OF SKIM

Although the unit volume computation indicates the possibility of skimmed income, the use of another traditional indirect method would help to confirm the fact that the owner is skimming. Consider the use of an accepted indirect method of proof such as a bank deposits analysis, source and application, net worth or any other method to support the unit volume calculation. Attempt to look beyond the books and records. Consider factors such as the purchase of assets, the taxpayer's financial status, the lack of a salary or draw from the business, to determine which method should be used. The negligence and/or substantial understatement penalty should be considered based on the facts and circumstances of each case. Coordinate with the Fraud Coordinator if the unit volume computation shows substantial amounts of unreported income and the disposition of the skimmed income can be documented.

A third party source told the Providence project group that it is not uncommon for pizza owners to take money out of the country. However, to prove that the owner or his or her nominees are taking the unreported income out of the United States is not an easy task. If there is a possibility that money is being taken out of the country, consult with International to develop the issue. This issue should be addressed on a case by case basis.

Consideration should also be given to whether additional information can be gotten by contacting former employees. Usually, these individuals know exactly how the business was operated and may be helpful in identifying schemes used by the owner. The former employees can also confirm allegations to solidify the case.

If appropriate, the examiner can also go to a bank or banks near the taxpayer and ask the head teller if the taxpayer comes in and makes cash conversions. (Small bills into large denominations.)

It may be difficult to prove income underreporting or skimming without more specific information, therefore, the agent must continue to look beyond the books and records and pursue other leads.

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Chapter 12

RELATED EMPLOYMENT TAX ISSUES

The most common problem identified during the examination of the pizza restaurants is the cash wages paid "off the books." This appears to be a common practice in the restaurant business. Many times, employees are paid with cash taken from the cash register and there are no payroll or time records maintained.

The obvious problem here is the avoidance of taxes. The owner avoids the payroll taxes, but in addition, the employee avoids paying tax on the wages. During the initial interview, the agent should pursue the possibility of cash payroll. Attempt to confirm the hours of operation and who performs specific functions at various times of day. It is nearly impossible to run a restaurant alone.

One agent used the purchase invoices to identify employees who were not on the payroll but were signing the daily purchase delivery slips. When the taxpayer was confronted with this information, he agreed that certain amounts of income was skimmed to pay these employees and he did in fact avoid the payroll taxes on these wages. Check to see if employees identified have filed tax returns using the IMFOLT command code on IDRS.

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Chapter 13

INADEQUATE RECORDS NOTICE

An inadequate records notice should be considered in all cases where the examiner determines that the taxpayer's records are inadequate. This is one effective tool that can be used to enforce compliance with the tax laws.

In those situations where the taxpayer does not keep the proper records to determine income and expenses, the case agent should refer to IRM 4271.21 for the guidelines for inadequate records notices. This will put the taxpayer on notice that the proper records must be maintained. This will also provide for a follow-up examination to confirm if the taxpayer has improved his recordkeeping.