



## Market Segment Specialization Program



# Mobile Food Vendors

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 3149-119 (4/95)  
TPDS 84082Y

# TABLE OF CONTENTS

## MOBILE FOOD VENDORS -- MSSP INDUSTRY GUIDE

	<b>Page No.</b>
<b>Chapter 1 -- Introduction</b>	
Purpose .....	1-1
Determining the Focus .....	1-1
Industry Background .....	1-1
Espresso Vendors .....	1-1
Food Catering Trucks .....	1-3
<b>Chapter 2 -- How to Identify Vendors and Tax Returns</b>	
County Health Department .....	2-1
Site-Plan Review .....	2-1
Locating Vendors .....	2-1
City Licensing Bureaus .....	2-1
Newspapers and Magazines .....	2-2
State or Local Industry Group .....	2-2
Summary .....	2-2

**Chapter 3 -- Introduction to the Audit**

Pre-Audit ..... 3-1

Books and Records ..... 3-2

Document Request ..... 3-2

Areas of Consideration ..... 3-3

    Accounting Method ..... 3-3

    Purchases ..... 3-4

    Inventories ..... 3-4

    Sales Tax ..... 3-4

    Mark-up ..... 3-4

    Car Expenses ..... 3-4

    Home Office Deduction ..... 3-5

    Supplies ..... 3-5

Initial Interview ..... 3-5

**Chapter 4 -- Audit Issues**

Gross Receipts ..... 4-1

Inventory and Cost of Goods Sold (COGS) ..... 4-1

Operating Expenses ..... 4-2

    Bad Debts ..... 4-2

    Car and Truck Expenses ..... 4-3

    Depreciation and IRC Section 179  
    Deductions ..... 4-3

    Interest Expense ..... 4-3

    Rent or Lease Expense ..... 4-4

    Taxes and Licenses ..... 4-4

Wages and Salaries Expenses .....	4-5
Home Office Deduction .....	4-5
Gains and Losses .....	4-5
Summary .....	4-6

## **Chapter 5 -- Audit Techniques**

Income in General .....	5-1
Screening and Pre-audit Considerations ....	5-2
Consideration of Internal Controls .....	5-2
Consideration of Personal Use .....	5-3
Consideration of Returns and Allowances ...	5-3
Estimating Techniques .....	5-3
Gross Receipts -- Mobile Catering Trucks .....	5-4
Estimating Techniques .....	5-4
Additional Considerations .....	5-6
Gross Receipts -- Espresso Vendors .....	5-6
Screening and Pre-audit Considerations ....	5-6
Consideration of Internal Controls .....	5-7
Estimating Techniques .....	5-9
Estimating Income from the Sale of Espresso .....	5-10
Estimating Income from the Sale of Italian Sodas .....	5-13
Estimating Income from the Sale of Baked Goods .....	5-13
Estimating Sales of Coffee Drinks Based on Milk Products .....	5-14
Estimating Income from the Sale of Other Items .....	5-15

Additional Considerations .....	5-16
In Depth Procedures such as Indirect Methods .....	5-17
Other Applications .....	5-17
Inventory and Cost of Goods Sold .....	5-18
Spoilage .....	5-19
Operating Expenses .....	5-20
Bad Debts .....	5-20
Car and Truck Expenses .....	5-20
Depreciation and IRC Section 179 Deductions .....	5-20
Interest Expense .....	5-21
Rent or Lease Expense .....	5-21
Taxes and Licenses .....	5-22
Wages and Salaries Expense .....	5-23
Home Office Deduction .....	5-24
Gains and Losses .....	5-24
Summary .....	5-25

**Chapter 6 -- Employment Taxes**

Employee or Independent Contractor .....	6-1
IRC Section 530 .....	6-3

**Chapter 7 -- Back-Up Withholding**

Internal Revenue Code Section 3406 .....	7-1
Abatement of Back-Up Withholding (IRM 4652).....	7-2
AIMS Procedures .....	7-3
Procedures for Asserting Back-Up Withholding (IRM 4696) .....	7-3
Substitute for Return Procedures (IRM 48(13)1) .....	7-3

**Chapter 8 -- Penalties**

General .....	8-1
Criminal Fraud Penalty: (IRC section 7201) .....	8-1
Civil Fraud Penalty: (IRC section 6663) .....	8-2
Accuracy-Related Penalty: (IRC section 6662) ...	8-2
Failure to File Correct Information Returns: (IRC section 6721) .....	8-3
Failure to Furnish Correct Payee Statements: (IRC section 6722) .....	8-4

**Chapter 9 -- Compliance 2000**

General .....	9-1
Compliance .....	9-1
Underreported Income .....	9-1
Summary .....	9-2

## Glossary

Accounting Terminology .....	G-1
Food Catering Truck Terminology .....	G-2
Espresso Terminology .....	G-2
Tasting Terminology .....	G-4
Espresso Drinks .....	G-6

## Chapter 1

### INTRODUCTION

#### **PURPOSE**

The purpose of this guide is to provide audit techniques to be used in the examination of taxpayers in the Mobile Food Vendors Industry.

#### **DETERMINING THE FOCUS**

All of the initial returns comprising this industry study were selected with the focus on two types of food vendors:

1. Food Catering Trucks
2. Espresso Carts.

As media attention touted the potential profitability of these businesses, it was observed that many street corner operations were operating at high volumes, principally in cash, and with little or no forms of internal controls. Recognizing the potential for income underreporting, projects were initiated to identify issues, determine the levels of compliance, and to developing audit techniques to assist examiners in future examinations.

This guide contains a considerable amount of data and estimates which resulted from the projects conducted. Please keep in mind that the validity of this information may need to be refined and adjusted for such factors as product mix, selling prices, costs, methods of operation, etc. based on geography, demographics, the evolution of the industry, and the mere passage of time.

#### **INDUSTRY BACKGROUND**

##### **Espresso Vendors**

In recent years there has been a massive proliferation of mobile espresso cart vendors in the Pacific Northwest. What is a mobile espresso cart vendor, or for that matter, what is espresso?



You may see the term "espresso" used in a number of ways. The most common usage is in reference to a concentrated, aromatic, and flavorful beverage brewed from coffee beans (espresso is usually brewed with only about one-fourth the amount of water per serving as is commonly used in drip coffees). The other distinguishing characteristic of espresso is that each cup is brewed separately for immediate consumption, rather than being brewed in quantity and allowed to sit.

Within the industry, the term "espresso" is often used in a broader context, and may refer to:

1. The brewing method (which uses pressure instead of gravity to brew).
2. The special blend of beans formulated for espresso machine use.
3. The roast color of the beans in the blend (which is a dark roast).

While the preceding offers a general description and definition of espresso, one should note that a wide variety of coffee drinks are prepared using the espresso brewing method, and the industry has developed a language all its own. (See Glossary.)

Espresso brewing processes have been around since the early 1800's, having first been invented in Europe. The process was introduced to the United States in the early 1900's, but popularity largely lagged until the early 1970's. About that time, coffee roasters in Seattle and Los Angeles began to educate the American coffee drinking public in the culture of "gourmet coffee." Still, it was probably not until the late 1980's that Seattle was dubbed "Coffee Capital of the Country" or as Seattleites would more commonly attest, "Latte Land."

While numerous coffee houses and a few espresso bars existed in Seattle as in all American cities, a revolutionary and interesting phenomenon began when an entrepreneur placed a cart on a street corner in downtown Seattle and began selling freshly made espresso drinks sometime in the 1980s. By 1990, Seattle experienced an explosion of "copy-cat" entrepreneurs, and as of this writing, it seems there is an espresso business on every street corner. Espresso businesses are no longer unique to Seattle; they have quickly expanded up and down both the West and East coasts, and according to a media representative, are now breaking new ground in the

Midwest. In addition, these businesses are not unique to downtown urban settings. They have proliferated throughout metropolitan areas and spilled over into suburban areas and smaller towns at an incredible rate.

Early vendors in our study area used carts which were similar to hot dog, soft drink, popcorn, and other street vendor carts that have been operated in cities across our country for decades. Early versions of the espresso cart generally had two large wagon wheels at one end and were usually stationary at the opposite end. The carts were approximately 6 to 8 feet long, about 24 to 36 inches wide, and about 4 feet in height. Equipment, located in and on top of the cart consisted of the espresso brewer and grinder, and an array of flavorings and supplies. The county health permit requirements stipulated that there be both hot and cold running water, refrigerator, appropriate electrical service, and provision for waste disposal. These items were easily incorporated into the body of the cart. In recent years, a product called "granita" has been added by many vendors. Granita is an iced-coffee drink similar to "slurpee" or "slushie" type soft drinks. It is generally mixed in a special granita machine which is usually located on top of the cart.

As the industry has grown, the traditional wagon wheel style of cart has largely given way to more modern carts which are increasingly more functional -- and expensive. More recently, drive-thru espresso stands have sprung up, often located on supermarket or shopping mall parking lots, sometimes using converted Fotomat booths, sometimes consisting of a custom designed kiosk, making use of an existing small building, or simply a canvas or plastic gazebo type tent.

Perhaps the final, or at least most recent, stage of industry development has been the incorporation of espresso bars in other established business including hospitals, supermarkets, convenience stores, filling stations, fast food and other restaurants and cafes, department stores and shopping malls, and specialty espresso cafes. There is even an instance of a dentist who operated an espresso bar in his dental office!

### **Food Catering Trucks**

The following information was obtained from a Revenue Agent group that examined commissaries. This information provides some additional background into the mobile food sales industry.

There are two types of catering trucks, hot trucks, Mobile Food Preparation Vehicles (MFPV), which allow food to be prepared as customers order, and cold trucks, Industrial Catering Vehicles (ICV), which sell only prepackaged foods. The hot trucks have at least a driver, (which is usually the taxpayer), and a cook, who may be a family member. The cold trucks in most instances, only need a driver since it is a self-service vehicle, however, they are not limited to just the driver.

The average cost of the trucks is approximately between \$50,000 - \$100,000. The trucks may be owned by one individual, serving as the owner/operator, or several individuals may own a fleet of trucks and lease them to various individuals to operate; or they can be individually owned and then leased to another individual to operate.

The drivers/owners of food trucks are linked to specific commissaries stocking and storing their trucks overnight. The commissary is a wholesale supermarket where the drivers are able to buy food and supplies in bulk. The trucks are assigned to a commissary and are required to park their vehicles there overnight for washing, unloading, and morning loading of food. The drivers purchase their goods for sale at the commissary, although you may discover that outside purchases were also made. The Department of Health Services have very strict requirements with regards to the purchase of food for sale. Food must be obtained from an approved vendor, approved facility, or approved commissary.

The owners and operators of the catering trucks have to meet certain requirements for various governmental agencies. The owners are required to register their vehicles with the Health Department. All vehicles must have a valid County Health Permit. Vehicles are usually inspected annually in order to renew their license by the Health Department. The license, showing the name of the owner, must be on display in the vehicle or on the persons of the driver. Selling any goods, wares, or merchandise on public streets and sidewalks on foot or using a pack, stand, or push cart is illegal without the approval of the Department of Building and Safety. (See Exhibit 1-1 for a listing of typical health code violations.)

The operators must also receive a "Retail Sales" Business Tax Registration Certificate. This certificate, issued by the City Clerk, is not a license or permit, but is used in accordance with the payment

of a business tax. All other laws of the city must also be complied. Operators are only allowed to sell in cities where they have obtained a business license. Each operator is assigned a territory. If their territory is within the city limits, they are allowed to stay at each location 30 minutes. They could be cited if they stay longer. Written permission must be obtained from the Health Department for longer stops. (See Exhibits 1-2 and 1-3 for other Health Department regulations.)

This page intentionally left blank.

**HEALTH CODE VIOLATIONS**  
(Check with local authority)

**Mobile Food Preparation Vehicles**  
Health Code Violations  
Department of Health Services  
City and County of Los Angeles

When conducting an examination of a hot or cold truck, the examiner should be cognizant of possible violations of the health code. Quite often, an operator may be fined for various violations and may attempt to write off the cost of the fine as a business expense. Needless to say, fines or tickets are not allowable as a business expense for tax purposes. Listed below are some of the more common violations which operators are cited for:

**Hot Trucks**

- a. Lack of hot running water at the sinks.
- b. Improper food temperatures.
- c. Unpackaged foods offered for customer self-service, including food within a self-service oven and pastries.
- d. Lack of proper dating on potentially hazardous foods offered for customer self-service.
- e. Gross unsanitary conditions, including vermin infestations (flies, cockroaches, mice, etc.)
- f. Sale of home-prepared foods.
- g. Discharge of waste water on the ground while operating.
- h. Operating without a valid Public Health Permit.

**Cold Trucks**

- a. Improper food temperatures.
- b. Unpackaged foods including pastries.
- c. Lack of or improper dating on potentially hazardous foods.
- d. Gross unsanitary conditions including vermin infestations.
- e. Sale of home-prepared foods.
- f. Operating without a valid Public Health Permit.

When other types of violations are observed, a certain amount of time will be allowed for the violations to be corrected. If the corrections are not made within the time allotted, the matter may then be referred to the City or District Attorney's office for prosecution.

**Exhibit 1-1 (2 of 2)**

Repeat violations involving the sale of improperly labeled packaged foods offered for self-service from either a hot or cold truck may also be referred to the City or District Attorney's office for prosecution.

In general, the driver will be held responsible for all operational violations, such as food temperatures, dating, and cleanliness. The owner will be held responsible for all structural violations. Sometimes, both parties (owner and/or operator) will be held responsible; for instance, if there is no hot water because the heating unit is inoperable.

**STATE HEALTH SERVICES REGULATIONS**

(Check local authority for requirements)

**Mobile Food Preparation Vehicles**

Department of Health Services  
State of California

The Health & Safety Code requires that unpackaged food shall not be displayed for self-service on a Mobile Food Preparation Vehicle (hot truck). Also, that all food prepared on a hot truck and offered for self service to the public shall be wrapped or packaged to protect the food from contamination and shall be labeled as required in the Health & Safety Code.

The current requirements for packaged foods, available for self-service and prepared on the hot truck are as follows:

- The name and place of business of the manufacturer, packer or distributor.
- An accurate statement of the quantity of the contents in terms of weight, measure or numerical count.
- The common or usual name of the food.
- An ingredient statement listing the common or usual name of each ingredient in descending order of predominance if the food is fabricated from two or more ingredients.

It has come to our attention that the ingredient labeling requirement has caused considerable difficulty. With the diversity of foods available on a mobile unit, it is believed that this requirement may be impractical to comply with due to limited storage space for labels. Also, this requirement could be considered deceptive because operators tend to generalize ingredients statement labels.

Therefore, under the authority specified in the Health & Safety Code, we will no longer require a listing of ingredients as one of the labeling requirements for packaged food prepared on a hot truck for self-service.

All packaged food offered for sale from a place other than from where it was manufactured, shall still comply with existing requirements of the Health & Safety Code and the County Public Health Code.



We will continue to apply our enforcement stand regarding labeling violations as indicated in our Health Code Enforcement letter to the industry. Repeat violations, involving the sale of improperly labeled packaged foods offered for self-service from either a hot or cold truck, may be referred to the City or District Attorney's office for prosecution.

We hope that this change will eliminate any remaining confusion regarding the minimum labeling requirements for self-serviced packaged foods prepared on a hot truck.

**COUNTY HEALTH SERVICES REGULATIONS**  
(Check local authority for requirements)

**Mobile Food Preparation Vehicles**  
Department of Health Services  
County of Los Angeles

1. The name and address of the owner or operator of the vehicle (or the commissary address) shall be on each side of the vehicle in letters at least three (3) inches high.
2. All areas of the vehicle where food or beverages are displayed or sold shall have tight fitting doors, which when closed, enclose the compartment.
3. All materials used in vehicle construction must be easily cleaned and washable. The vehicle's interior shall be cleaned daily and kept in good repair.
4. Insecticides or poisons shall not be carried in the food storage or display areas of the vehicle. Such products may be carried in the driver's compartment.
5. Single-service utensils such as forks, spoons, napkins, straws, etc., shall be stored in a manner that protects them from contamination. (For example, forks and spoons shall have only handles exposed).
6. The operator of the vehicle must have adequate containers for refuse. The operator is also responsible for the sanitation and clean-up around the immediate area of his stops.
7. All food within the vehicle must come from a source approved by the Health Department. To provide for this, all food packaged must state the name and address of the manufacturer and include a list of ingredients. **NOTE: DO NOT SELL UNLABELED FOOD!**
  - A. Food or beverages prepared in a private home shall not be carried on the vehicle.
  - B. All perishable food such as sandwiches, TV dinners, meat, pies, burritos, etc., **MUST BE MARKED** with the **DATE** offered for sale and placed either in the hot holding device or placed under refrigeration. No perishable food is to be carried in the storage side of the vehicle or in the vehicle's cab. All perishable foods must be marked "PERISHABLE, KEEP REFRIGERATED."

**Exhibit 1-3 (2 of 4)**

- C. **NOTE:** Many frozen foods such as TV dinners, and burritos may not be marked for the date offered for sale at the catering house. These foods must be marked or checked for markings by the DRIVER OR LOADER PRIOR to being placed in a heating or warming device.
  - D. All food and beverages must be wrapped, packaged or dispensed in a manner that protects the food from dust, flies, vermin, droplet infection or other contamination. PASTRIES must be wrapped and labeled. SUGAR and STRAWS must be wrapped or placed in an APPROVED dispensing device.
  - E. No food or components of food which are required to be wrapped and dated shall be rewrapped or used, sold or given away, nor shall the date be removed or obliterated after the one "Day Prepared For" inscribed on the container or package.
- 8. All food in the hot food cabinet must be 140 degrees Fahrenheit or higher at all times. A thermometer must be placed in the hot cabinet to facilitate the checking of the temperature.
  - 9. Readily perishable sandwiches such as egg salad, chicken salad, meat sandwiches, custard and whipped cream pies must be maintained at or below 45 degrees Fahrenheit.
  - 10. Ice on the vehicle is not meant for human consumption. If you provide ice for the customers, it must be in a separate ice chest.
  - 11. Can openers are allowed to be attached to the exterior of the vehicle but must be tightly secured while the vehicle is moving. They shall be easily detached without the use of tools.
  - 12. All vehicles MUST have a valid County Health Permit. The license showing the name of the owner must be on the vehicle or on the person of the driver. The license DECAL must be placed on the left rear of the vehicle. **NOTE:** Check with the cities in which the vehicle is used for other business license requirements.
  - 13. All operators shall wear clean outer garments and keep their persons clean at all times when engaged in handling food, utensils, or equipment.

14. Service stops shall not be longer than 30 minutes. Written permission must be obtained from the Health Department for longer stops.

The following are additional requirements pertaining to Mobile Food Preparation Units (Hot Trucks):

1. All windows, doors and other openings shall be in good repair and provided with screens or flaps to prevent the entrance of flies. Pass through openings shall not be larger than 216 square inches and shall be covered when not in use.
2. The door to the driver's compartment shall be self-closing and kept closed when not in use.
3. All perishable cold food MUST be maintained at or below 45 degrees Fahrenheit.
4. When the mobile unit is moving there shall be no exposed food in the unit.
5. All operators shall wear clean outer garments, keep their hands and fingernails clean, and wear head bands, caps or devices to restrain falling hair.
6. The use of tobacco in ANY FORM is PROHIBITED in the food preparation area.
7. All operators are to wash their hands before beginning work and after visiting the toilet.
8. All foods shall be obtained ONLY from an APPROVED vendor, APPROVED facility or APPROVED commissary.
9. ALL PASTRIES must be wrapped and labeled if displayed in customer self-service areas. Unwrapped pastries must be kept within the vehicle and dispensed by the operator in a sanitary manner.
10. Hot and cold running water MUST be supplied to the handwash and utensil washing sinks. The hot water heater must be functioning during all stages of food preparation, during the daily run and in the commissary yard.
11. If stopping for longer than sixty (60) minutes, approved toilet facilities must be available for use by the food handlers within one hundred (100) feet of the vehicle. Written permission must be obtained from this department for all such stops.

**Exhibit 1-3 (4 of 4)**

12. Any discharge of waste water onto the surface of the ground is strictly prohibited. Waste tank outlets shall be kept closed or tightly capped and shall be maintained in good repair.
13. All waste water generated by the vehicle shall be disposed of at an approved commissary or other facility approved by the Health Officer.

**CITY HEALTH SERVICES REGULATIONS**

(Check local authority for street vendor requirements)

**Street Vendors Requirements**

City of Los Angeles

Selling any goods, wares or merchandise on public streets and sidewalks on foot, or using a pack, stand or pushcart is illegal. It is also illegal to sell from vacant lots, auto service stations or any other private property (abandoned or not) without the approval of the Department of Building and Safety.

Persons operating food catering vehicles may sell, provided that all of the following conditions are met:

1. The vehicle must be registered with the State Department of Motor Vehicles.
2. The vehicle must be approved by the County Health Department.
3. When stopping or parking on public streets, all signs must be obeyed. Certain other stopping or parking restrictions must also be complied with.
4. Only temporary stops on private property route locations may be made.

The "Retail Sales" Business Tax Registration Certificate issued by the City Clerk is not a license or permit. Persons selling goods, wares or merchandise within this City must obtain a certificate and pay a business tax. In addition, they must also comply with all other laws of the city.

This page intentionally left blank.

## Chapter 2

### HOW TO IDENTIFY MOBILE FOOD VENDORS AND TAX RETURNS

#### COUNTY HEALTH DEPARTMENT

Information on mobile food vendors can be obtained through your local county health department. They can provide detailed information pertaining to each vendor including business name, location, owner's name and address, phone numbers, and dates the permit was issued and expired. If possible, try to obtain a permit listing based on the specific permit class in sorted alphanumeric format by location.

#### SITE-PLAN REVIEW

The county may also require a "site-plan review," which may include such information as menu items, vehicle design, storage area and availability of rest rooms for employees. Although such information was not utilized during the projects conducted, it is well to note that this information may be available if needed.

#### LOCATING VENDORS

One problem encountered by some examiners was the lengthy time lag between the initial requests from the service center and actually beginning the examination of returns. As a result, a number of businesses had vanished or moved during that time, and due to the explosive growth in the industry, many vendors were not identified. Consequently, exercise care in identifying and securing tax returns of vendors. An alphanumeric listing by location has the distinct advantage of allowing someone to drive by the locations and confirm the business is still in operation, and also to identify vendors which may not have been found (for whatever reason) from the health department permit listing. This approach was used in follow-up procedures and was very successful in obtaining appropriate returns for further examinations.

#### CITY LICENSING BUREAUS

Another method of identifying vendors may be to contact city licensing bureaus. Although the project group found that the cities they contacted did not have data



stratified as to type of business in a manner that would be useful, nonetheless, they feel the availability of usable information may vary from one municipality to another and it may be worth checking into.

### **NEWSPAPERS AND MAGAZINES**

Researching newspaper and magazine articles is another method of identifying vendors. A number of such articles were obtained during the project formulation phase. Upon obtaining transcripts for seven vendors named in one newspaper article, it was found that two had not filed tax returns since 1987. (One of the vendors was quoted in the article as stating that he was operating two espresso carts selling over 600 cups per day ... estimated gross profit from coffee alone was approximately \$289,000.) (See examples in Exhibit 2-1.) It may be possible to research such articles at your local public or college library. In addition to identifying vendors and providing information about volume and profit, these articles generally contain a significant amount of useful information about the state of the industry in a particular area.

### **STATE OR LOCAL INDUSTRY GROUP**

Finally, there may be a state or local industry group or organization in your area that may provide additional information. It may be possible to obtain membership lists, and such organizations also commonly have useful industry information.

### **SUMMARY**

In conclusion, the County Health Department permits information has been found to be the most useful, and if properly organized, the most efficient means of identifying vendors. If you undertake such a project and cannot obtain listings by location, you may want to establish your own database from the information that is available, physically survey the locations to refine your potential espresso vendor list, and then secure returns accordingly. Keep in mind that many of the businesses are proprietorships and you may need to perform IDRS research to identify the particular tax returns needed. The examination process may be

expedited by using the RTVUE/BRTVUE to initiate the audit while waiting for the actual returns to be received.

**NOTE:** A quick inspection of gross receipts, COGS, and calculation of gross profit may be one of the best indicators of audit potential. More detailed information is presented in the section on Audit Issues and Audit Techniques which follow.

This page intentionally left blank.

REFERENCES TO SOURCES OF GENERAL INFORMATION

**Books**

Jurich, Nick, **Espresso: From Bean to Cup**, Seattle: Missing Links: Press, c1991.

Sturdivant, Shea, **Espresso! Drinks, Desserts and More**, Freedom, CA : Crossing Press, c1991.

Tekulsky, Matthew, **Making Your Own Gourmet Coffee Drinks**, New York: Crown Publishers, c1993.

Mariano, Bernard N., **In Search of the Espresso Secret, Crema**, Chicago, IL: Trendex International, c1991.

Barbieri, Heather Doran, **Seattle Emergency Espresso**, Alaska: NW Books, c1992.

**Newspaper Articles**

**Los Angeles Times**, 12/31/90, P.32;46

Bolzar, John

In the Northwest, specialty coffee is the hot drink.

18 col. in.

**The New York Times**, 10/25/89, P.B7 & C6

Espresso and Cappuccino.

**The Wall Street Journal**, 10/1/90, P.B1

Lublin, Joann S.

He probably finds strong coffee helps to set your teeth on edge.

This page intentionally left blank.

## Chapter 3

### INTRODUCTION TO THE AUDIT

#### PRE-AUDIT

As you are reviewing the tax return, begin thinking of questions to ask the taxpayer during the interview. (See sample interview questions at Exhibit 3-1.) Remember, you are not only auditing the tax return, you are auditing the taxpayer. For example, what address is the taxpayer using as his or her place of business? Is he or she claiming rental expense, or office in the home? Is the taxpayer also working in an unrelated job as an employee? How much time does he or she spend in the business? Look carefully at how the Schedule C flows to the rest of the return. Does the taxpayer have a loss, or did he or she make a profit? If a loss, how did he or she live? Consider whether the tax return makes good economic sense. Many businesses receive income which should be reported on Form 1099. When you deal with cash businesses, consideration should be given to the issuance of Forms 1099 since there is no income accountability to or by a third party. Internal documents are available to the examiner which will identify reported transactions made by the taxpayer in cash over \$10,000. These can be helpful when dealing with cash businesses. Often, in a high cash business, taxpayers purchase large items with cash from their business. Two of the internal documents available and used to report these transactions are:

1. Form 8300
2. Currency Transaction Report (CTR).

Form 8300 is completed by any person in a trade or business who receives more than \$10,000 in cash in a single transaction or in related transactions in the purchase of real estate, cars, jewelry, boats, etc. The CTR is submitted by financial institutions when withdrawals or deposits of \$10,000 or more are made. Consideration should be given to secure these documents, especially when there is a significant difference between the taxpayer's standard of living and the income reported on his or her tax return.

## BOOKS AND RECORDS

The taxpayers in the Mobile Food Vendors project were generally unsophisticated and maintained poor records, or in some cases none at all. The ice cream vendors, produce trucks, etc. in many cases did not maintain any records of income or expenses. The catering trucks, kept records of their purchases for the most part, and generally maintained better records of income and expenses. In the absence of actual records it is difficult to reconstruct income using a direct approach.

Among the items that should be requested from the taxpayer during the examination of this industry are the taxpayer's daily purchase invoices received from their suppliers. The purchase invoice will identify exactly what was purchased. When examining the catering truck invoice, review it closely because it should give you an indication as to whether the taxpayer sells cold or hot food. If the items purchased are ground beef, buns, vegetables, etc., for example, the taxpayer probably has a "hot truck." If the items purchased are sandwiches and other cold and pre-packaged foods, then the taxpayer is probably operating a "cold truck."

The food sales businesses operate strictly in cash. Their income is in cash and all of their inventory purchases, as well as the majority of their other expenses, are all paid in cash. Since these expenses are paid in cash they will not have cancelled checks or money orders to substantiate the payment of invoices. Purchases are either paid on the spot to the commissary, or credit may be extended by the commissary and the invoice is paid after daily sales are received.

## DOCUMENT REQUEST

The document request should include, but not limited to, the following items:

1. All books and records of the business.
2. All bank records for both business and personal accounts, which includes all checking and savings accounts. Include all cancelled checks and deposit slips.
3. All summary sheets used to prepare the tax return.

4. Sales receipts/invoices issued to customers.
5. Purchase invoices.
6. Beginning and ending inventory records.
7. All Forms 1099 and Forms W-2 issued and/or received.
8. Copies of prior and subsequent year tax returns.
9. Employment and Sales Tax returns.
10. Depreciation records.

During your pre-audit, you may find other items that appear to be questionable. Be sure to include these items on the Information Document Request. Remember, it is important to make the document request as complete as possible.

## **AREAS OF CONSIDERATION**

### **Accounting Method**

The tax return should identify what type of accounting method the taxpayer is using (cash, accrual or hybrid) to compute taxable income. Consider the nature of the business. If the taxpayer maintains an inventory, he or she should operate using the accrual method. If the taxpayer maintains an inventory and is not using the accrual method, the taxpayer's method of accounting should be changed and an IRC section 481(a) adjustment should be made.

1. In the food sales industry, the taxpayers report their income on the cash method of accounting. Under this method, income is reported when it is actually received. Expenses are taken when they are actually paid. Inventory is minimal, due to perishable goods.
2. You may also find taxpayers using a "hybrid" method for computing taxable income. This method allows the taxpayer to be on the accrual method with respect to purchases, sale of goods, accounts payable and accounts receivable. However, regulations could authorize them to use the cash method with respect to expenses such as rent, car or truck, insurance, etc.



## **Purchases**

Is the taxpayer claiming a deduction for returns and allowances? Is this amount included in purchases? Is the taxpayer double deducting? Is the taxpayer claiming a deduction for spoilage? Is the amount reasonable? Is it a reduction in purchases? It could be possible for the taxpayer to have spoilage; however, if he or she continues to have a high amount on a daily basis, you may want to look at how prudent a business person he or she is.

## **Inventories**

Is the taxpayer required to maintain year end inventory controls? Are inventory records maintained properly? How is the inventory accounted? Is the taxpayer properly on the accrual method of valuing the ending inventory? Generally, food sale businesses have very little stock on hand at the end of the year due to perishables. However, this issue should be pursued as the food sales business can have substantial nonperishable items on hand at year end.

## **Sales Tax**

Was sales tax taken as a deduction on the tax return? If the taxpayer calculated gross receipts from invoices did it include sales tax? If yes, then the taxpayer would be allowed the sales tax deduction on his or her return. To take the deduction, it must be reported in gross receipts.

## **Mark-up**

Analyze the mark-up percentage. Is it reasonable considering the taxpayer's business? Food sale businesses generally markup their cost by at least 100 to 200 percent. For example, if they purchase an item for \$.50, they will generally sell it for \$1. Understand, however, that the taxpayers often give discounts to customers. Consider these mark-up guidelines only as a starting point in determining their reasonableness in relationship to income being reported on the tax return.

## **Car Expenses**

Is the taxpayer claiming vehicle rental expense, depreciation, or both? If he or she owns the vehicle, the taxpayer would be entitled to claim the depreciation. If the taxpayer is leasing the vehicle, he or

she would claim vehicle rental expense as a lessee/operator. In most instances, the taxpayer owns the vehicle which is being used in the business, therefore, he or she is an owner/operator. The difference between the two will also be reflected in other expenses such as insurance, repairs, etc.

### **Home Office Deduction**

Is the taxpayer claiming a deduction for use of his or her home for the business? Does IRC section 280a apply regarding rules for taking this deduction? Basically, within the Mobile Food Vendors Industry, the mere fact that these businesses work out of a vehicle, would indicate that they must conduct a percentage of their business out of their residence. However, a home office deduction is available only if the taxpayer meets the requirements of regular and exclusive use under IRC section 280A(c)(1) and meets the comparative analysis tests as applied in *Commissioner v. Soliman*, 113 S. Ct. 701 (1993). See Rev. Rul. 94-24, 1994-15 I.R.B. 5; Notice 93-12, 1993-8 I.R.B. 46. Because most of the Mobile Food Vendors Industry delivers goods and services at a location other than the home (that is, in the mobile vehicles), few taxpayers in this industry will qualify for a home office deduction.

### **Supplies**

What types of supplies are required? Should these items be inventoried? Is there any personal use of these supplies? Within the food sales industry, there would be paper products, cleaning supplies, condiments not for sale, towels, etc. The quantities of certain supply items (such as plates, cups, and paper bags) consumed in the business may be used in applying the percentage (or unit mark-up) method of determining gross income, or in certain instances as discussed later in this guide.

### **INITIAL INTERVIEW**

The initial interview is the most important step in the audit process. It is at this point that the examiner is able to gather information from the taxpayer as to his or her business activity and his or her standard of living. Therefore, it is important that the taxpayer is present during the initial interview; he or she is more familiar with his or her personal and business matters than the representative. Based on the results of the interview, the examiner should have a good basis

on which to determine whether or not the taxpayer is properly reflecting his or her income, and decide if the focus of the audit will be on income or expenses.

Ensure that questions are specifically stated and geared directly toward the taxpayer's situation. It is a good practice to pre-plan questions prior to your meeting with the taxpayer. In the pre-planning process, allow for expected and unexpected responses. Ask open-ended questions, requiring a response other than yes or no questions, to allow the taxpayer an opportunity to respond to the questions, and allow the examiner an opportunity for follow-up questions or responses. Taxpayer responses must be accurately documented in your workpapers. In the food sales industry, which operates primarily in cash, it is extremely important that you tie down all known sources of income during the initial interview. Form 4822, Statement of Personal Living Expenses, is a useful tool which encompasses all types of expenses, from personal grooming to household expenses to contributions. This form should be completed by the taxpayer and carefully reviewed by the examiner to determine its reasonableness. It is important that you go over this form with the taxpayer so he or she can explain the circumstances surrounding the various expenses and make any necessary changes. Use this form as a tool only, and understand that you will not be able to determine the taxpayer's exact personal living expenses for the year under audit, unless you have actual documentation to verify expenses.

**SUGGESTED INTERVIEW QUESTIONS**

**Background Questions**

1. When did you begin your business?
2. How much was the initial investment?
3. How was it financed? Borrowed funds, gift, inheritance or purchase?
4. What type of expansion or growth have you had in your business? What was the cost?
5. What was your gross profit/loss in prior years?
6. What is your expertise/experience in this field?
7. What is your educational background?
8. Who usually operates the business? Who operates the business when the usual operator is on vacation or sick?
9. How many locations or trucks does your business handle?
10. Did you acquire or dispose of any business assets during the year?
11. Do you pay rent at the commissary or business location? How much?

**Daily Business Routine**

1. What type of business is this?
2. What type of products are sold?
3. What is the territory/route traveled daily?
4. What are the hours and days of operation?
5. How many employees or independent contractors do you have?
  - a. Family members?
  - b. Breakdown of duties.

6. Were Forms W-2 or Forms 1099 issued?
7. What is your typical day-to-day operations? (Describe it.)
8. Are you involved in the trading or bartering of services?
9. Do you keep any records or data pertaining to the "mix" of products? (This would pertain to size and type of drinks, single versus double-cupping, etc.)
10. Do you keep any records of, or can you estimate how many customers you serve (that is, per day, week, or month)?
11. Do you keep any records of, or can you estimate, the average dollar amount of sale per customer?

**Licenses and Taxes**

1. Were you required to have a business and/or health license?
2. What other types of licenses were required?
3. In what cities were you licensed to sell your goods?
4. What were the fees and how were they paid?
5. What were the expiration dates for these licenses?
6. Are you required to file Sales Tax Returns? If so, how do you account for sales taxes on a daily basis?

**Banking Practices**

1. How many bank accounts (checking and savings) did you have, both business and personal?
2. Where are they located and what are the account numbers?
3. What are the sources of funds deposited into each account? Were there regular transfers between accounts?

4. Were there any undeposited sources of income?
5. Did you have any cash hoards? If so, how much and where?
6. Who makes the deposits?
7. Is any cash removed for personal use or expense?
8. How much cash on hand did you have at the beginning and end of the year?
9. Did you borrow any money for business or personal use during the year?
10. Did you have any non-taxable sources of income?

**Accounting System**

1. What method of accounting were you using: cash, accrual or hybrid?
2. What type of accounting system were you using: Single or double entry?
3. What do your accounting records consist of: Informal or formal books?
4. Who maintained the daily accounting records? Was this the same person who did the banking?
5. What documents were used to prepare the tax return?
6. Who was involved in the preparation of the tax return?
7. Are all sales included in the amount reported as gross sales?

**Internal Controls**

1. How are sales accounted for? (That is, cash register, etc.?)
2. How often are receipts recorded?
3. What percentage of cash receipts are deposited?
4. How often are receipts deposited?

5. What percentage of purchases are in cash?
6. Did you extend credit to your customers? If so, who to and for how much?
7. Did you cash payroll checks for customers?
8. Is the cash reconciled at the end of day? Are any other controls used, such as cup counts, etc.?

**Inventories**

1. What was the average volume of goods sold on a particular day?
2. What was the average daily sales?
3. Where did you purchase goods sold?
4. What was the mark-up percentage used? How was it determined? Market survey?
5. How often were purchases made? Were they all from the same company?
6. What was the average amount of each purchase?
7. What inventory valuation method was used, cost, lower of cost or market?
8. How often were inventories taken? By whom?
9. Do you maintain any other storage locations, specifically for inventory or other business items?
10. Was there any theft or loss of product or other property?
11. Was any products given away or sold at discounts?
12. Did you sell any products in "bulk"?
13. Did you remove any products for personal consumption?
14. Do suppliers give return credits for unused products?
15. Were any large purchases of supplies or merchandise made at the end of the year?

16. Do you keep track of how many cups of coffee, cokes, or other mixed beverages are sold each day? How do you measure this?

**Vehicle Expense**

1. Were you buying or leasing the vehicle used in your business activity? If leased, were payments based in whole or part on sales volume?
2. Type, make and model of vehicle? License plate number?
3. If catering truck, is it a hot truck (cooked food), or a cold truck?
4. When was the vehicle placed in service?
5. What was the total cost of the vehicle? How was it paid?
6. If financed, what was the monthly payment? To whom was it payable?
7. How many miles per gallon does your vehicle get?
8. Where did you store your vehicle after working hours?
9. What is the daily average number of miles you travel for business?
10. What was the total number of business miles incurred during the year?
11. What repairs/maintenance costs did you incur during the year?
12. Do you carry additional insurance for your food truck?



This page intentionally left blank.

## Chapter 4

### AUDIT ISSUE

#### GROSS RECEIPTS

Gross receipts is far and away the major issue for potential adjustments of a material nature. Taxpayers examined were either very compliant, or very very noncompliant in reporting income. A substantial number of returns examined resulted in some underreporting of income and many had substantial underreporting between 10 to 50 percent. In addition, several fraud referrals were made and accepted, and the taxpayers agreed to the Service's findings. Several nonfilers were also identified.

In conjunction with this, it is also important to note that there are start-up costs associated with the food vendors, as is generally the case in any business. Since many of the businesses are sole proprietorship operations, part of the gross income probe should include identification of the source of the taxpayer's funds for start-up costs.

#### INVENTORY AND COST OF GOODS SOLD (COGS)

Inventories were seldom reported on the returns examined. When they were reported they were often deminimis in absolute terms, but on occasions were material in relative terms. Inventory items that are commonly present include food items such as coffee, sugar and sweetener, milk, flavorings, soft drinks, and pastries. Nonfood inventoriable items include cups, lids, napkins, and stirrers.

It was generally found that the taxpayers did not stockpile food or supplies. Coffee and cups were generally purchased at least once per week, while milk and pastries were often purchased daily. Other items were generally purchased less frequently as needed. One may generalize, and assume it is likely in most cases, that the taxpayer would have less than a 1-week supply of food and supplies at year end.

Note also that the taxpayers' classification of supply items may vary from inclusion in COGS to classification as operating expenses. Although potential inventory adjustments may be small in absolute terms, it is imperative to consider inventories in the development

of income estimates. Due to the high gross profit margin on certain items, a seemingly insignificant dollar amount of inventory equates to a significant dollar amount of sales.

If a vendor has merchandise on hand at yearend such that use of inventories is required (that is, more than a de minimis amount), then the taxpayer's method of accounting must be changed to the accrual method.

**NOTE:** See Exhibit 4-1 for additional technical discussion of inventory and change of accounting method issues.

The examiner should employ procedures to assure that all purchases have been accounted for in computing COGS. While this may seem to be a routine measure, it is wise to remember that markups of 100 percent, 200 percent, and more is not unusual in this industry. (However, lower markups in the area of 50 percent have also been encountered in some examinations.) Consequently, "proportional underreporting" (underreporting both COGS and gross receipts) may occur resulting in significant income underreporting.

Spoilage is another factor that should be considered. While there should generally not be a substantial amount of spoiled or damaged goods, some is inevitable. The examiner should verify that double deductions are not claimed (that is: Deduction in computing COGS and deduction as a separately classified expense item). Also, taxpayers often purchase for personal consumption and costs may be deducted within COGS or as spoilage. Such personal expenses are specifically disallowed under IRC section 262.

## **OPERATING EXPENSES**

### **Bad Debts**

Since most taxpayers in the mobile food industry use the cash method of accounting, deductions for bad debts would generally be unusual. Because their bookkeeping and accounting systems are usually quite unsophisticated, it is possible that credit has been extended to customers and (1) the cost of goods was not deducted in COGS or, (2) the amount receivable was actually included by the taxpayer in reporting gross receipts. Assuming the debt is otherwise deductible under IRC section 165, a bad debt may be allowable even to cash method taxpayers in these circumstances.

## Car and Truck Expenses

There is little question that some transportation expenses are incurred by most mobile vendors. Both food and supply items are often picked up by the vendors, rather than being shipped or delivered by the suppliers. However, in the cases examined, very few taxpayers kept any actual records of vehicle use.

Car and truck expenses are often overstated, and in many cases, were based on the standard mileage rate applied to a generous estimate of business miles. The issue of whether expenses actually represent commuting should also be addressed.

In some areas mobile food caterers use the services of "strikers" to wash their trucks. These "strikers" work at the large catering wholesalers washing and loading trucks, and payments are often made in cash.

## Depreciation and IRC Section 179 Deductions

The most common property for which taxpayers take deductions are the vehicle and equipment. Two major problems were found in this area:

1. Taxpayers often depreciated the vehicle and equipment over a shorter period than allowable. Currently, the vehicle and related equipment should be depreciated over a minimum of 5 years under MACRS. We found taxpayers using 3-year depreciation periods. This issue should be pursued under IRC section 446 (Change of Accounting Method). If the adjustment is substantial enough, the taxpayer may qualify for an IRC section 481 adjustment which spreads the adjustment over a 3-year period.
2. Vehicles and equipment may either be purchased or leased. If leased, they are generally for a period of 1 to 3 years. But in all instances encountered, the leases were capital leases with bargain purchase options assuring the taxpayer would in fact purchase the machine (bargain purchase options ranged from \$100 to 10 percent of the total cost). Note that under current law, the taxpayer must own the vehicle to use the standard mileage rate for claiming car and truck expenses.

## Interest Expense

Deductions for interest expense are not uncommon in the mobile food industry, and often are not of a material amount. Examiners should be alert to consistency in

accounting method (that is: Cash method taxpayers may not deduct interest unless actually paid) and also verify that the interest expense is business related, not personal.

### **Rent or Lease Expense**

Virtually all espresso vendors, whether operating mobile carts, drive-through's, or other fixed locations, will be renters, while mobile caterers usually own their vehicles. Rents vary of course and agreements may be written or oral. Most cases encountered involved written lease agreements. These may be for a fixed monthly fee, percentage of gross receipts, or a combination of both. It is most useful to determine what records are used to establish the base for variable lease agreements (who keeps the records? How reliable are they? Does the payee/lessor perform any verification)? In one case, the taxpayer leased under a contract with a major department store, was provided a cash "bank" each day and a cash register, and was required to "prove the cash" each day. It was ultimately determined that only about 50 percent of the sales were rung up on the cash register, and the lessor was apparently none the wiser. Lessors are often noncorporate taxpayers and information returns are seldom, if ever, filed by the payor/lessees. Again, this could lead to an information referral or an additional examination.

It is also important to determine where the espresso cart or catering truck is stored during nonoperating hours. There is sometimes a need for the taxpayer to make special accommodations by leasing storage space or possibly securing the cart in a truck.

### **Taxes and Licenses**

It is customary for state sales taxes to be included in the "menu price" of each item. Taxpayers vary in their treatment of sales taxes: Some include this amount in gross receipts and deduct the corresponding amount under operating expenses, but most encountered simply reduced gross receipts. For cash basis taxpayers this may be a potential adjustment area because some taxpayers would not report or pay over sales taxes to the state. It is also well to note that if underreported income is determined for a cash method taxpayer and sales taxes were not reported on the underreported income, the entire underreported amount is taxable since the taxes were not paid over to the state.

Excluding sales taxes, there are generally no significant tax items normally present on the tax return, with the possible exception of payroll taxes. Routine procedures used in other business examinations may be employed.

### **Wages and Salaries Expense**

It is almost impossible to operate a mobile food vendor business without labor in addition to the owner. Operations typically are conducted 12 to 16 hours per day and 6 to 7 days per week. There is little question that hired help meets the criteria of common law employees: Some vendors appropriately treat their workers as employees and file required employment tax returns, etc. But a substantial number treat workers as contractors and may or may not file information returns, and some pay cash without filing information returns. This is a factor to be considered in determining the mobile food vendor's gross income, and may also result in an information referral or an additional examination. In all cases where labor is hired to operate the business, it is likely that FICA, FUTA, and income tax withholding provisions are applicable. (See the sections on Employment Taxes and Back-up Withholding.)

### **Home Office Deduction**

Mobile food vendors seldom qualify for home office deductions, although deductions for use of the home for storage of inventory may be encountered and are usually allowable. This subject is discussed in more detail in the Introduction to the Audit and Audit Techniques sections of this guide. Examiners should be alert to this issue and pursue factual development as needed.

### **GAINS AND LOSSES**

From time to time, taxpayers may replace carts, trucks, or other equipment. Particularly in the case of proprietorship operations, the taxpayers' lack of sophistication regarding income taxes sometimes results in omission of these transactions on their tax returns. Since many of the vehicles and related equipment items are initially expensed under IRC section 179, there is usually a gain to be reported upon resale.

Another similar issue encountered was mobile food vendors who also dealt in the purchase and sale of carts, trucks and equipment. Under such an

arrangement, the carts, trucks, or equipment are inventory, and profits from such sales result in ordinary income (subject to SE Tax if applicable).

As discussed above, the presence of inventories will have an impact on the method of accounting that the vendor is required to use.

In one examination, the taxpayer acquired and sold three vehicles and related equipment and failed to report any of the sales on the original return. In preparing for the examination, the CPA discovered these sales and proposed to amend the return by reporting these sales via Form 4797, rather than as Schedule C profit.

Still another situation encountered was a taxpayer who entered the trade or business of marketing an espresso business "package." Basically, the taxpayer selected a location, negotiated a lease, acquired equipment and then marketed the package, including training in operations and accounting records, to the buyer. The seller had claimed depreciation on the assets and further attempted to reduce the profit on the sale by allocating costs to his own labor which was also not reported as income.

## **SUMMARY**

Issues encountered in the examination of mobile food vendors are seldom of a sophisticated or technical nature. Proprietorship and family partnership operations are typical of small family-owned businesses in various industries, particularly those that are cash intensive. The most useful information needed to perform quality audits of these businesses is the knowledge of how the business operates, the products involved, and general cost-volume-profit relationships. Chapter 5, Audit Techniques, provide more detailed information on these subjects.

One final note: As the industry evolves and matures, there appears to be an increase in the operation of multiple locations by a single taxpayer. Often these operations involve partnerships or corporate entities. Thus issues unique to such entities (such as basis, passive activities, dividends, salaries, etc.) may be encountered with more frequency.

**TECHNICAL DISCUSSION OF INVENTORY AND METHOD OF ACCOUNTING**

If a vendor has merchandise on hand at yearend, such that use of inventories is required (that is, more than a *de minimus amount*), then the taxpayer's method of accounting must be changed to the accrual method, Treas. Reg. section 1.446-1(c)(2)(i). Furthermore, it is inappropriate to determine ending inventory under a new method (accrual) while using the old method of accounting (presumably cash) to determine opening inventory. *Wayne Bolt & Nut C. v. Commissioner*, 93 T.C. 500, 506 (1989). It is well settled that opening and ending inventory must be computed pursuant to the same method. *Wayne Bolt & Nut*, 93 T.C. at 506; *Primo Pants Co. v. Commissioner*, 78 T.C. 705, 725 (1982); *Fruehauf Trailer Co. v. Commissioner*, 42 T.C. 83, 107 (1964), *aff'd*, 356 F.2d 975 (6th Cir. 1966).

A change in method of accounting generally requires an adjustment under IRC section 481(a). IRC section 481(a) adjustments are required to offset duplications or omissions of income or expense resulting from a change in method of accounting. The IRC section 481(a) adjustment represents the cumulative difference between the present and proposed methods of accounting as of the beginning of the year of change. Consequently, if a vendor has merchandise on hand at the yearend such that inventories and the accrual method are required, opening inventory for the year of change must be revalued under the new method when making a IRC section 481(a) adjustment.

IRC section 471(a) provides that whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income.

Treas. Reg. section 1.471-1 provides, in part, that in order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. See also Treas. Reg. section 1.446-1(a)(4)(i).

IRC section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.



IRC section 446(b) provides that if the method used by the taxpayer does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. See also Treas. Reg. section 1.446-1(b)(1).

Treas. Reg. section 1.446-1(c)(2)(i) provides that in any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales.

The term "merchandise" is not defined in the Code or regulations. However, in *Wilkinson-Beane, Inc. v. Commissioner*, 420 F.2d 352 (1st Cir. 1970), aff'g T.C. Memo. 1969-39, the First Circuit, after canvassing the authorities, defined "merchandise" as personal property held for sale. Because the vendors have personal property held for sale, the issue is whether the vendors should be on the accrual method of accounting. Under Treas. Reg. section 1.446-1(c)(2)(i), if use of inventories is necessary, the accrual method of accounting must be used with regard to purchases and sales.

On the other hand, it was suggested in dicta in *Ezo Products Co. v. Commissioner*, 37 T.C. 385 (1961), that the presence of inventories does not necessitate a change in the taxpayer's method of accounting (from the cash method to the accrual method) if the inventories are inconsequential or consist primarily of labor. See also *Estate of Roe v. Commissioner*, 36 T.C. 939 (1961). But see *Herberger v. Commissioner*, 195 F.2d 293 (9th Cir. 1952), cert. denied, 344 U.S. 820 (1952) (suggesting that wherever a taxpayer uses inventories, regardless of size, it must use the accrual method). The Service has consistently required the accrual method if inventories are required under Treas. Reg. section 1.471-1, even though this requirement is not an absolute and unvarying rule.

In *Asphalt Products v. Commissioner*, 796 F.2d 843 (6th Cir. 1986), the Sixth Circuit concluded that while the accrual method did not always have to be used in conjunction with inventories, its use was required if there were significant accounts receivable resulting from the sales of merchandise. In *J.P. Sheahan Associates, Inc. v. Commissioner*, T.C. Memo. 1992-239, the Tax Court characterized this as a "substantial identity in results" test. Under this test, a taxpayer with inventories might be permitted to continue to use the cash basis if the taxpayer's income computed on the cash method did not vary significantly from its income computed on an accrual

basis. The focus is on whether there are substantial accounts receivable. But see *Thomas Nelson, Inc. v. United States*, 694 F. Supp. 428 (M.D. Tenn. 1988) (if the taxpayer is found to have title to inventory, then use of the cash method is incorrect as a matter of law).

The issue for the typical vendor with one or two locations is whether the method of accounting used in the business (presumably the cash method) clearly reflects income under IRC section 446. If the method of accounting does not clearly reflect income, the Commissioner has the discretion to require computations under the method which, in her opinion, does clearly reflect income. *Commissioner v. Hansen*, 360 U.S. 446, 467 (1959). On the other hand, although the Commissioner's broad powers in this regard are well settled, the Commissioner may not force a taxpayer to change from a method of accounting which does clearly reflect income to a method which in the Commissioner's opinion more clearly reflects income. *Garth v. Commissioner*, 56 T.C. 610, 618 (1971), *acq.*, 1975-1 C.B. 1. "Whether the particular accounting method clearly reflects income is a question of fact. *Coors v. Commissioner*, 60 T.C. 368, 394 *aff'd sub nom. Adolph Coors Co. v. Commissioner*, 519 F.2d 1280 (10th Cir. 1975).... If a taxpayer's method of accounting is set forth in the Internal Revenue Code or in the regulations, respondent may not reject that method as not providing a clear reflection of income if the taxpayer has applied that method on a consistent basis. *Hallmark Cards v. Commissioner*, 101 T.C. No. 1 (July 12, 1993), slip op. at 19. Thus, the issue involves factual line drawing, rather than clear cut absolute principles which may be objectively applied.

Because the typical vendor stops at a wholesaler every business day for some items, and at least weekly for others, a significant portion of the goods purchased must be depleted on a daily or weekly basis. The vendors presumably have *de minimis* amounts of merchandise inventory on hand at year end. Likewise, the typical vendor purchases and sells goods solely for cash. Therefore, the accrual method may not be required because the vendor's income computed by the cash method would be virtually identical (because there are no receivables) to income computed on an accrual basis. For a typical vendor with one or two locations, there will be a substantial identity of results between the current method (presumably the cash method) and the accrual method.

IRC sections 446 and 471 and the regulations thereunder "vest the Commissioner with wide discretion in determining whether a particular method of inventory accounting should be

disallowed as not clearly reflective of income." *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 532 (1979). See also Knight-Ridder, Epic Metals Corp. v. Commissioner, T.C. Memo. 1984-322, aff'd without published opinion, 770 F.2d 1069 (3d Cir. 1985); *Fame Tool & Manufacturing Co., Inc. v. United States*, 334 F. Supp. 23 (S.D. Ohio 1971). Since a typical vendor may only have *de minimis* goods on hand at year end you may choose not to utilize your resources for such a small adjustment even though technically the taxpayer should be required to maintain inventories.

However, if the amount of merchandise on hand at year end is not *de minimis*, the taxpayers must use the accrual method of accounting for the purchases and sales of its merchandise. This change in method of accounting consequently would require a IRC section 481(a) adjustment to prevent income and expense from being omitted or duplicated. Generally, the amount of the IRC section 481(a) adjustment is the determined opening inventory under the new method (because the basis attributable to the opening inventory presumably was previously deducted). See *Pursell v. Commissioner*, 38 T.C. 263, 276 (1962). However, the proper amount of the IRC section 481(a) adjustment will vary, depending on methods used and the particular facts. (For instance, while there may be a positive component to the IRC section 481(a) adjustment for omitted opening inventory, there may be a negative component related to trade accounts payable which were not deducted under the taxpayer's method of accounting (presumably cash).)

Inventories may not be *de minimis* if the vendor has multiple locations, depending on the particular facts of the taxpayer. In this atypical case, the vendor may be purchasing in bulk and inventory at year end may include not just items on the carts but items stored for later use.

If the examiner determines that a change in accounting method is required, Revenue Procedure 92-20 should be consulted for additional guidance relating to the year of change and IRC section 481(a) adjustment period.

## Chapter 5

### AUDIT TECHNIQUES

#### INCOME IN GENERAL

As mentioned earlier, underreporting of gross receipts is probably the most significant potential issue in auditing mobile food vendors. The mobile food vendor business tends to deal primarily in cash receipts from customers. As with any business that is cash intensive, the accuracy and adequacy of reporting income is highly contingent upon ownership and the owner's propensity for full and accurate reporting.

IRC section 446(a) states, "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." However, many of the taxpayers in the food industry do not adequately maintain books and records.

IRC section 446(b) is the authority for IRS to use an indirect method in determining the correct taxable income.

#### Extract

IRC section 446(b)

\*\*\* If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

There are five indirect methods which have been developed by the Internal Revenue Service:

1. Bank deposit analysis
2. Cash transactions (cash-T)
3. Source and application of funds
4. Net worth
5. Percentage (or unit mark-up).

The bank deposit, cash transactions, and percentage (or unit mark-up) methods have generally been found to be the most useful in examining mobile food vendors. While it is beyond the scope of this guide to provide in-depth instruction on the use of these methods, simplified general instructions are included in the section devoted to examining gross receipts for mobile catering trucks. More detailed discussion and analysis is included in the section devoted to examining gross receipts for espresso vendors because variations in mark-up and relative sales mix can vary considerably.

Along this line, it is well to point out, however, that examiners have been able to secure taxpayer agreement to income adjustments without exception based on estimating techniques. If sufficient factual information is obtained from the taxpayer through interview and actual examination of the books and records, it is difficult for the taxpayers to dispute the ultimate findings. See Exhibit 5-1 for a technical discussion of income reconstruction.

### **Screening and Pre-audit Considerations**

The potential for underreported income can probably best be determined during the pre-audit by computing the gross profit margin. Care must be taken to observe whether supplies are included in Cost of Goods Sold (COGS), or separately claimed as operating expenses.

### **Consideration of Internal Controls**

The evaluation of internal controls is a vital step in planning further procedures. Once this evaluative process is completed, and the examiner has determined the nature and extent of record keeping and documents available for examination, it is fairly simple to refine the audit scope and select appropriate audit procedures to test gross income.

Where ownership was by proprietorship or partnership with the owners being principally involved in day-to-day direct operations, there were seldom any internal control features employed. Even when owners employ some part-time labor there is seldom any internal control -- the owners usually trust their own instincts about the trustworthiness of their employee. This same situation can be present in corporate vendors operations where the owners are principally involved.

## Consideration of Personal Use

When considering cost of goods, consider personal use of food purchased for sale through the commissaries. Has the taxpayer identified any amounts used personally and excluded them from cost of goods sold? Also, in regards to food left over at the end of the day, many taxpayers will say they give it away or throw it away. If they are purchasing more food than they sell each day and state that they give it away, are they being prudent business persons? Consider their original intent; is it to purchase goods for their own personal use?

## Consideration of Returns and Allowances

This amount should be a credit allowed to customers for returned merchandise and, therefore, should be a reduction in figuring gross receipts. It could also be taken as a credit to purchases. However, ensure that the deduction is not taken twice.

## Estimating Techniques

### Overview

Estimating gross income of mobile food vendors can be accomplished with the investment of relatively few exam hours, and can result in a very accurate estimate of the gross income actually derived from the operation.

There are two very important steps in this process. First, it is important to obtain sufficient testimony from the taxpayer in the interview to both evaluate the credibility of testimony, and also to facilitate and corroborate the calculations. (See Exhibit 4-1, Sample Interview Questions.)

Second, information concerning the COGS (including some supply items) is needed, preferably in the form of the original invoices. Because the markup (or gross profit percentage) is quite consistent for most products sold by mobile catering truck vendors, use of the unit markup method (discussed below) is relatively simple to perform. However, there is considerable more variability in the markup of products sold by espresso vendors and more detailed information concerning COGS is usually needed, as will be discussed later. It is possible to analyze the major components of the COGS and project the expected income from each major component. There will of course be some variation from

one business to another, but there is sufficient consistency within the industries to make this relatively simple.

## GROSS RECEIPTS -- MOBILE CATERING TRUCKS

### Estimating Techniques

#### Estimating Income Using Bank Deposit Analysis

The first method, bank deposit analysis, should be used when taxpayers deposit the majority of their receipts into either their personal or business account and the taxpayer has complete bank records. This method assumes that the taxpayer deposits all receipts into one account or several accounts. However, when you have businesses that deal strictly in cash, as in the case of the food industry, it is highly unlikely that (1) a bank account exists, and (2) if it does, that the taxpayer deposits the majority of all cash receipts received. Mostly, these individuals pay their personal expenses as well as their business expenses in cash. If any cash is deposited, it is the remaining income after paying personal and business expenses.

Again, you need to ascertain from the taxpayer what percentage of receipts are in cash, and what percentage is deposited. If the taxpayer uses the cash method of accounting, and deposits the majority of the receipts, you can use the Simplified Bank Deposit Analysis Method to determine if an understatement exists. (See Exhibits 5-2 through 5-6, Bank Deposit Analysis Forms.) If the taxpayer uses the accrual method of accounting, the following adjustments for accruals are made to gross income:

Gross Income:	(Net deposits + Cash expenditures)
Add:	+ 12/31 Accounts Receivable balance)
Minus:	<u>- 1/1 Accounts Receivable Balance</u>
Equals:	Corrected Gross Income Adjusted By Accruals

#### Estimating Income Using the Cash Transactions Method

The second method is the cash transaction method along with the Personal Living Statement, Form 4822. A Cash-T should be prepared prior to the initial interview with the taxpayer. This will quickly identify a potential understatement if one exists. Before receiving the completed Form 4822 from the taxpayer, you could use the Department of Labor

Statistics on family income and expenses to get an estimate of the taxpayer's total personal living costs.

Once you receive the completed Form 4822, go over it line by line with the taxpayer so as to ensure that they understand the figures. Remember too, that when a return is selected for audit it is usually a couple of years old already and it may be difficult for the taxpayer to remember the exact amounts. Have the taxpayer either base figures on the current year and make adjustments, or review cancelled checks, receipts or other actual source documents from the year in question to give a more accurate amount. Remember, the Cash-T is only as good as the information received. If all information is not available or supplied, you will not obtain a complete picture of the taxpayer's income.

**Estimating Income Using the Percentage or Unit Markup Method**

The final method, percentage or unit markup was the method most utilized in this industry study. This method should be used if it has been determined that the above two methods are inadequate in determining taxable income. It is most effectively used in the computation of gross income in the food industry since many catering trucks only maintain records of cost of goods sold and may not present a clear picture of their personal expenses. This method will determine whether the taxpayer is using the proper markup on his or her cost of goods sold. It has been determined through many sources that the markup for food sales could be anywhere between 100 percent and 200 percent, but is generally 100 percent for cold foods and 200 percent for hot foods. This should be used as a guide or starting point when determining gross receipts. Markup is calculated as follows: Total sales minus COGS divided by COGS: (Use this computation to determine the mark-up percentage and compare it to that claimed on the return.)

$$\frac{\text{Total Sales} - \text{COGS}}{\text{COGS}} = \text{Markup Percentage}$$

If you have determined the markup claimed on the return is inaccurate and it is necessary to recalculate total sales, it is calculated as follows: Cost of Goods Sold multiplied by 100 percent plus markup. This study's information regarding markup was also confirmed by the



American Entrepreneurs Association, who published a guide on mobile restaurants. (See Exhibit 5-7 for Markup Table.)

### **Additional Considerations**

One examiner discovered that some catering truck operators would sometimes run a tab for the customers during the week and act as a check cashier on Fridays. The truck operator usually charges a fee for cashing these checks but often does not include the fees as income. However, the fee is additional income to the taxpayer. An examiner also discovered that many commissaries paid dividends to the fleet operator based on a percentage of purchases. This is another indication that there may be unreported income from sources other than the sale of goods.

### **GROSS RECEIPTS--ESPRESSO VENDORS**

#### **Screening and Pre-audit Considerations**

According to marketing data obtained from the major equipment supplier in the study area, the average sales price per cup of espresso was \$1.51 and average profit \$1.26 (including all ingredients and packaging supplies in COGS), yielding a gross profit margin of 83 percent. These estimates, however, were based on sales of "single shot" drinks and appeared to underestimate the packaging costs by as much as 20 percent. It is customary for vendors to increase the price of the drink by 25 cents for each extra "shot" of espresso: Using the approximate cost of 8 cents for the extra "shot" of espresso, the gross profit on the second shot is reduced to 68 percent which has a slight diluting effect on the profit margin for the total drink. Gross profit margins for Italian sodas are similar to those of espresso drinks.

The gross profit margins on other items, such as muffins, pastries, and cookies can vary considerably, but are usually 50 percent or more. Again, this can have some diluting effect on the vendors' gross profit margin as a whole, and of course will vary depending on the product mix. Gross profit margins in the range of 75 to 80 percent are probably more in line with reality. (Even if taxpayers do not maintain separate sales accounts for different menu items, it is possible to segregate and stratify COGS by items or similar items to facilitate a reasonably accurate revenue

estimate, as is further discussed in the sections that follow.)

Most of the returns examined by the project group showed gross profit margins between 40 and 60 percent, which indicated a good likelihood of unreported income.

### Consideration of Internal Controls

Larger businesses operating multiple locations, regardless of the entity form, tended to employ some measures of internal controls. The three most common, and most easily administered of these controls are "grinder counts," "cup and lid counts," and cash reconciliation.

Most newer coffee grinders (these are commercial models) are or can be equipped with a counter. By recording, monitoring, and reconciling the grinder readings, it is possible to determine how many potential drinks are produced during a given interval. Each activation of the grinder produces sufficient ground coffee for one "shot" of espresso. Grinders are generally set to dispense between 6 and 7 grams of ground coffee per "pull." Some newer models are easily adjustable by the user, while others require disassembly by a technician. It is very unlikely vendors would operate their grinders outside this range, because the quality of their product depends in large part on the proper mix of grounds and water.

At 28 grams per ounce, each pound of coffee beans will produce between 64 and 75 "shots" of espresso. Espresso drinks are generally singles (one "shot") or doubles (two "shots") and usually sell at a ratio of about 1:1, thereby averaging about 1.5 "shots" per drink, so, each pound of coffee used produces between 43 and 50 drinks. (Note: We recommend that the examiner obtain taxpayer estimates to determine ratios; but, beware as always of potential self-serving testimony.) Average selling prices in locations audited in the Espresso Project generally ranged between \$1.65 and \$1.75 (including sales tax) per espresso drink which equates to about \$71 to \$88 in gross income per pound of coffee. It should be noted that there may be some loss to spillage, promotional giveaways, personal consumption, and bulk sales (sales of coffee beans by the pound), but overall this was found to be minimal: A rule of thumb of 5 percent is

not an unreasonable assumption when no documentation exists. This subject will be further explained in the section on estimating techniques.

A second control feature that can be easily employed is the use of "cup and lid counts." Vendors seldom use more than one cup for each cup sold and instances of "double cupping" (using two cups for one drink) are rare. The most commonly encountered "double cupping" is related to sales of Americano (basically, one or two shots of espresso diluted with steaming hot water). This is more prevalent when paper cups are used because the heat of steaming hot brew penetrates in a most uncomfortable manner. However, Americano has also been shown to represent a relatively small portion of the sales mix, accounting for perhaps 3 to 5 percent of all espresso drinks sold. Business owners are keen to the fact that each cup costs money (about 5 cents) and reduces their profit, and other than Americano, they normally will not "double cup" unless requested. The sales mix in the Seattle market has traditionally been about 85 to 90 percent latte, mocha, and flavored latte (these drinks all use steamed milk) and the milk is not nearly as hot as steamed water.

Given the close correlation between the number of cups and lids used and the number of drinks produced, it is easy to perform the math and complete an income estimate. The vast majority of drinks are sold with lids, and without exception it has been found that vendors purchase more lids than cups. One might reasonably conclude that the number of drinks produced (and presumably sold) should lie somewhere between the number of lids used and the number of cups used. See samples of revenue estimates in Exhibits 5-8 through 5-17.

The third common and simple internal control feature found is simply the reconciliation of the till. This practice is seldom if ever employed in owner-operated businesses and small family-operated businesses. It is often used in situations where the business operates at multiple locations. There are of course variations of the actual methods used, but basically, the employee is required to balance the cash in the till at the end of the shift to the sales reported or recorded. In some cases, the till is counted down to a preset amount and the employee may be responsible for making the bank deposit for the excess. An interesting related issue was discovered in auditing a sole proprietor vendor who operated multiple locations. Although the owner

rigorously enforced the till reconciliation policy, sales were recorded by the employees under a manual entry system in a notebook. A one month sample of the cash reconciliations showed significant overages, which when projected over the year amounted to about \$10,000. This taxpayer reported sales on the tax returns based on the amounts on the daily sales/cash reconciliations without any adjustment for cash over/short.

Overall, it is expected the first two methods will be more effective than the last because it is as easy for employees to neglect recording sales as it is for the owner operator. Consequently, this control feature should not be relied on, but, cash reconciliations may be useful as corroborating evidence. While on the subject of cash reconciliation, it should be noted that while many locations do have cash registers, there are still those that rely on a manual hand entry or tally system to record sales. A few will make no sales recording at all. It is important to determine how the taxpayer determines gross receipts for tax purposes. Most often the cash method of accounting is employed and quite frequently only what goes into the bank gets reported. Payment of cash from the till for supplies is a common practice (as is the taking of owner's draws) and there is considerable adjustment potential in cases where the income goes unreported and the expense is claimed. The most common occurrence of cash payments tends to be for small supply items like napkins, sugar, and syrups, but we also quite frequently observed cash payments for coffee, cups, pastries, and other items. (This can potentially be thousands of dollars during the course of the year.)

## **Estimating Techniques**

### **Overview**

The most accurate and reliable estimating method involves varied applications of the percentage (or unit markup) method. The ratio of espresso drinks to other products sold by the traditional espresso vending business has been approximately 75 percent espresso drinks to 25 percent for Italian sodas (more about these later) and other products including pastries, muffins, and cookies. During the past couple of years this appears to have been changing, and certainly varies from one vendor location to another. Additional products such as granita, bottled seltzers, bottled or canned soda drinks, soups, and in one observed

instance, roses, have been added to the menus. Also, iced coffee drinks, such as iced latte, have become increasingly popular during hot summer months. Consequently, it is a good idea to observe the location in operation if possible and take note of menu items and prices, and to follow up as necessary through interview queries. Even where many other products are sold, espresso is still generally the mainstay and will account for the majority of total sales dollars. Espresso drink sales can be quite accurately estimated using bases of coffee and/or cups and lids. It is a good idea to use both, as one should corroborate the other.

### **Estimating Income from the Sale of Espresso**

#### **Estimating Sales Based on Coffee Consumption**

To estimate income from sales of espresso drinks via the coffee method, the following information is needed:

1. Copies of invoices for all coffee purchased during the year. This is a major expenditure and we seldom encountered taxpayers who did not retain these. Most vendors purchase all their coffee from one supplier and make their purchases at consistent intervals throughout the year (usually at least weekly).
2. An estimate of the average number of "shots" per drink sold. This is best obtained from the taxpayer, but if they don't know it should be relatively safe to use the ratio of 1.5 "shots" per drink which have corroborated by examinations. (Alternatively, one might divide the total "shots" produced by the total cups used to obtain an approximation.)
3. An estimate or determination of the number of "shots" the taxpayer's grinder produces per pound of coffee. As mentioned earlier, grinders currently in use will produce between 64 and 75 "shots" per pound of coffee, depending on the grinder setting. For the project, examiners usually used 60 for income estimates. In one instance where the taxpayer objected to the 60 "shot" assumption and insisted that their grinder yielded 35, the examiner went to the cart location and observed an actual "pull" test conducted by the taxpayer. The result was 58 per pound.

4. Documentation or an estimate of any bulk sales (sales by the pound of unground beans) and any coffee removed for personal use.
5. An estimate of losses due to spillage, theft, or any other similar factor.
6. Information concerning any marketing or promotion in which the customer was given drinks without charge. (For instance, many espresso vendors offer punch cards to the customer, and after the customer purchases so many drinks -- usually about 10 - they are rewarded with a free drink.)
7. An estimate of the average selling price per drink. The taxpayers are usually reluctant to make such an estimate, so your interview skills are vital to obtain this information. It is possible to set up a hypothetical situation with the taxpayer and get responses to a series of questions that will let you determine this average. For instance, you can create a hypothetical sample of the sale of 10 drinks and ask the taxpayer, based on their experience, how many will be lattes? Americanos? Mochas? Cappuccinos? etc. You can also ask, how many will be singles? Doubles, etc. Finally, determine from the taxpayer's menu or from oral testimony the selling price of each drink. Through this approach you can quite easily, based on the taxpayer's representations, determine ratios and extend the prices and then determine the average number of shots per drink and the average selling price per drink. (See the product sales mix data grid in Exhibit 5-10.) It is recommended that estimates be based on information developed from the taxpayers and their records, as opposed to using industry data. Note, however, that taxpayer testimony varying materially from industry norms may lack credibility and should probably be corroborated by some more objective evidence.
8. Determine whether any applicable sales taxes are included in the selling price.
9. Documentation or a reasonable estimate of the amount of coffee beans in beginning and ending inventories.

If your income estimate ultimately indicates underreported income, it is a good idea to have all the

above well documented. It is very easy to set up a workpaper or spreadsheet to document coffee purchases. In a number of examinations, the examiners in the espresso project had headed up workpaper columns (see examples in Exhibit 5-11) and had the taxpayers prepare schedules while they performed other exam procedures. This seldom took the taxpayer more than about half an hour; then all they had to do was perform minimal tests of their accuracy and total the columns. If coffee purchase invoices are not available or are incomplete, alternative techniques can be employed. If the total dollars spent and the price per pound is known or can be determined, it is simple math to determine how many pounds of coffee were purchased and used.

A sample worksheet outlining the calculations used to compute the income from this source can be found in Exhibit 5-9. While coffee purchases are normally paid for by check, it is a good idea to inspect the invoices looking for cash purchases, since this may represent income that was not reported and will be corroborative to estimates of underreported income.

#### **Estimating Sales Based on Cup and Lid Consumption**

To corroborate the coffee use estimate, or in extreme cases as a substitute procedure, the "cup and lid count" method can be used also quite easily. Espresso vendors normally purchase cups and lids from a single supplier, but even if they purchase from several suppliers, adequate schedules can easily be prepared. The primary objective is to determine how many cups and lids were consumed. Similar to the preceding method, beginning inventories need to be accounted for and any shrinkage loss and free drinks need to be factored into the equation. The only other factor of significance that needs to be determined is whether and to what extent the vendor "double cups." Again, this information is quite simple to obtain in the interview, and can also be corroborated by a brief observation of the espresso vendor in operation.

**NOTE:** Vendors typically use 8 oz. and 12 oz. hot cups for espresso and may use either paper or styrofoam. Italian sodas are most often sold in 16 oz. plastic cups.

A sample worksheet outlining the calculations used to compute income from this source can be found in

Exhibits 5-12 and 5-13. In addition to cash purchases, the examiner should also be alert to possible purchases of items for personal use or consumption.

### **Estimating Income from the Sale of Italian Sodas**

Italian sodas are cold drinks that are rising in popularity. The basic Italian soda consists of approximately two ounces of flavored syrup, several ounces of club soda, a generous amount of cubed ice, and are often complemented with one or two ounces of milk or cream. As noted above, these are commonly sold in 16 oz. plastic cups.

The flavored syrups most commonly used (currently) come in 26 oz. bottles, and in a wide array of flavors. Taxpayers have sometimes stated that they use 2 to 3 oz. of syrup per drink, but what is observed is that the use of 1 to 2 oz. is the norm. The cost of these syrups to the vendor usually ranges from \$3 to \$3.50 per bottle, depending on volume purchased and supplier.

Using techniques similar to those described above for estimating espresso drinks, it is relatively simple to estimate the income from the sale of Italian sodas. Simply determine how many drinks can be produced from each bottle of syrup used, multiply times the number of bottles of syrup used, and multiply the result times the selling price. See Exhibits 5-14 and 5-15 for sample workpapers using this method.

**NOTE:** It may be possible to corroborate this estimate based on the number of plastic cups used. This will probably depend on whether the taxpayer uses unique cups for this product. If iced coffee drinks such as granita or iced latte are sold in the same cups this may require some additional procedures or allocations appropriate to the situation.

### **Estimating Income from the Sale of Baked Goods**

Sales of peripheral or complimentary items such as muffins, pastries, and cookies are increasing with maturation of the industry. Estimating income from these sales is actually not as difficult as at first might be imagined.

In the case of mobile food vendors, the amount of space available is usually limited, and the amount of space a vendor may occupy may be limited by the Health Department Regulations. Consequently, most mobile



espresso vendors do not offer a wide variety of food items. In addition, the number of food vendors supplying the espresso vendor is usually limited to a very few.

Similar to estimating income from the sale of drinks, income from the sale of baked goods can be easily estimated by multiplying the quantity purchased times the selling price. This can be done for each item, or if the espresso vendor maintains a consistent profit margin on these products, the total dollars purchased can simply be grossed up to account for the profit margin using the percentage method. Examiners have noted that there is also very little waste or spoilage associated with selling these products. Espresso vendors typically purchase these several times a week, and in some cases daily, to maintain fresh products. In some instances the supplier may actually deliver to the espresso vendor daily, and will give credit for any unsold product.

The additional income to the espresso vendor from the sale of baked goods should not be underestimated. One espresso vendor encountered had sold approximately \$20,000 per year in cookies from one location.

### **Estimating Sales of Coffee Drinks Based on Milk Products**

Espresso sales in the study area have traditionally leaned heavily in favor of lattes and other "milk" drinks (between 80 and 90 percent of all espresso drinks sold). Because of this, there is a tremendous volume of milk products used by espresso vendors including whole milk, skim milk, half and half, and whipped cream. The milk is steamed or frothed, depending on the drink, and added to the espresso.

**NOTE:** Steaming or frothing generally expands the volume of the milk, especially frothing, to two to three the original volume.

Flavorings or whipped cream may be added. Although it is more difficult to establish average amounts used, it is possible to corroborate the coffee and lid and cup count methods based on the usage of milk. The procedure is basically as follows:

1. Determine the ratio of "milk" based drinks for the vendor.

2. Determine, if possible, the ratio of each size of drink and compute an average number of ounces per drink.
3. Determine the "shot" ratio: Each shot of espresso produces about 1 1/2 ounces of liquid.  
  
(For these first three steps, note the usefulness of the data grid in Exhibit 5-10.)
4. Determine the additional liquid (milk product) needed on average to complete the average drink, keeping in mind that cups are seldom filled to the brim and that frothing tends to increase the volume of liquid.
5. Compute (from invoices) the total volume of milk used in ounces, and divide by the average number of ounces of milk used per drink. The result is the number of milk based drinks sold.
6. Divide the number of milk based drinks sold by its ratio to all espresso drinks sold. This will give you the total number of espresso drinks sold, which you can then multiply by the average selling price to estimate income.

See sample workpaper formats in Exhibits 5-16 and 5-17.

The variables associated with this estimating technique are generally greater than those involved in the other methods. For this reason, it is not recommended that this method be relied upon alone. Rather, it is more useful to corroborate the other methods, or possibly to help resolve differences in the results obtained from the other methods.

### **Estimating Income from the Sale of Other Items**

While espresso drinks, Italian sodas, and baked goods are the mainstays of the espresso vendor business, and account for substantially all the income derived from the business, it is not uncommon to encounter various sideline products. Among the more unusual encountered were roses and soups. Because of the many differences that can exist with respect to these items, not very much time was devoted to studying them during the espresso project. What is important to be aware is that other products may be sold, and particularly where they may be material, the examiner may elect to apply estimating techniques similar to those discussed above.

## Additional Considerations

### Tips

Tip cups are common on virtually every mobile espresso business encountered during the project. This is indeed an additional source of revenue that should be considered, but inquiries and observations led the examiners to conclude that it was virtually de minimis in the overall scheme of the business. Therefore, time was not spent developing any such data. Additionally, tip income in all likelihood can vary quite considerably, and it was concluded that accounting for this source of revenue might best be accomplished via the interview (keeping in mind, of course, that some testimony may be self-serving).

### Granita and Iced Coffee Drinks

Granita and iced coffee drinks are rising in popularity. Granita, a coffee drink similar to the "slurpee" or "slushie" is generally prepared in batches. The primary ingredients are coffee, sugar, milk, and ice, and the exact formula may vary from one location to another. Due to the variables involved, it is good to determine through the interview or observation whether the vendor sells granita or iced coffee drinks, and to obtain as much detailed information as possible regarding the amount sold (that is, number of drinks sold per day, or ratio to sales of other drinks), size, type of cups used, selling prices, etc. An estimate of sales of these drinks can be included in the overall income estimate where sufficient materiality exists to warrant the additional procedures.

### Lost or Damaged Product

When preparing estimates as outlined above, keep in mind that there is inevitably some product loss in any food business. An example of this is when the espresso machine is initially set up at the beginning of each day: It is common to run two or three drinks just to get the brewer activated and running properly. Based on the testimony of several taxpayers who were deemed as highly credible, losses and spillage should usually be minimal, and it was concluded that "normal" product loss should not exceed 5 percent, and in most operations is probably much less.

As previously noted, there should also be little loss of baked goods resulting from overpurchase, spoilage, etc. This is so primarily because of the frequency of which these items are purchased and because some suppliers offer full return credit for damaged or unsold product.

A vendor may try to deduct spoilage on his or her tax return. The taxpayer will argue that he or she has to throw out perishables every day and should be allowed some amount for spoilage. While a vendor may have some spoilage, the amount is usually reflected in his or her cost of goods sold. Because the spoilage amount is already included in the cost of goods sold, no separate deduction is allowed. A separate deduction in addition to the cost of goods sold reduction would give a taxpayer a double deduction.

### **In Depth Procedures Such as Indirect Methods**

Many of the espresso businesses are sole proprietorship (Schedule C) operations, and many partnerships and corporate entities involved in this industry are family operated or closely held, and in many cases are owner operated. While the estimating techniques discussed above are extremely useful in determining the correct amount of income derived from the business, it is often difficult to trace unreported income to specific expenditures. In some instances it may be necessary to expand the audit scope to include the employment of indirect methods to the taxpayer as a whole. Instructions on these procedures are outlined in the Internal Revenue Manual (IRM) and in various IRS training materials. Keep in mind that estimation alone may not be sufficient to sustain the proposed adjustments and, therefore, other techniques may have to be applied.

### **Other Applications**

The preceding discussion of techniques for estimating income derived from mobile espresso vendors evolved primarily from industry study and examination of returns of these types of businesses. The espresso industry extends and continues to evolve into other type of situational settings. Espresso bars are proliferating into many other existing businesses including restaurants and cafes, fast food operations, department stores, supermarkets, "mom and pop" groceries, and convenience stores. Thus, an espresso bar may be a significant income producing segment of a

business not exclusively devoted to marketing espresso products. The information in this guide, and particularly in this section, should be useful in auditing an espresso bar segment of other businesses.

### INVENTORY AND COST OF GOODS SOLD

Most of the returns examined by the Espresso Project Group did not report any inventories. Taxpayer education and future compliance can be greatly enhanced by addressing the inventory issue.

If inventories are required in a particular vendor's situation, leading to a change in the vendor's method of accounting, then IRC section 481 adjustments will also need to be considered.

Auditing purchases and cost of goods sold (COGS) has the distinct advantage of employing dual purpose tests, that is to establish the accuracy of deductions for costs of sales and to make estimates of sales. Because there are relatively few suppliers of product and supplies, detailed examination in this area is easily and efficiently performed.

Inclusion of personal expenses in purchases is common. Many supply items are often purchased at commissaries, supermarkets, and discount stores. Inspection of these sales receipts may reveal purchase of unrelated food, housewares, cosmetics, clothing, and many other items of a personal nature.

The following is a brief description of the items usually included in cost of goods sold of espresso vendors:

1. Coffee beans -- There is usually only one supplier of this product. Payment is usually by check, but some purchases may be by cash. Most coffee costs between \$4.85 and \$5.15 per pound, with decaf usually about 30 cents per pound higher. Premium blends cost about \$7.75 to \$8 per pound.
2. Cups and lids -- There is usually one primary supplier of cups and lids, although it is not uncommon to find these items purchased occasionally from commissaries or supermarkets. Most espresso vendors purchase most cups and lids from the coffee company, specialty paper companies, discount supermarkets or commissaries, or other

institutional suppliers. Prices for cups range from about \$42 to \$53 per case of a thousand. Lids cost about half the price of cups and are also usually purchased in thousands.

3. Italian soda syrups -- These are generally purchased from a single supplier, and may be purchased by the case (usually 12 bottles) or in single bottles. The cost is approximately \$3 to \$3.50 per bottle.
4. Muffins, pastries, cookies and other baked goods - Espresso vendors sell a variety of baked goods from various suppliers. Prices vary considerably.
5. Milk products -- Some businesses have a single supplier for these products, while others purchase from various stores and supermarkets. This often is dictated by the location of the business. Espresso vendors located near a supermarket or other grocery stores often purchase from these nearby locations. This can lead to dozens of grocery store receipts for these purchases and can make reconciliation quite tedious. In this situation the inclusion of personal items is quite common and purchases are often by cash from the till. There are milk companies who deliver directly to the espresso vendor's location on a daily basis. These companies usually bill weekly or monthly and payments are usually by check.
6. Napkins, sweeteners and other items -- Such items may be purchased from an institutional supplier, or they may be purchased at supermarkets, etc. Again, inclusion of personal items appears to be frequent. Payments are made both by cash and check.

### **Spoilage**

In food sales, taxpayers often claim an expense for spoilage in the miscellaneous deductions for operating expenses. Generally, this is not allowable if the item was already expensed in computing COGS because it would result in a double deduction. If COGS was adjusted to exclude spoilage, then a separate deduction would be allowable. However, the examiner should at least consider whether the amount is reasonable and whether the taxpayer is exercising prudent business practices.

## OPERATING EXPENSES

### Bad Debts

In unusual circumstances, a cash method taxpayer may be entitled to a bad debt deduction. If the taxpayer is not required to use inventories and has not already taken the purchase costs into account as cost of materials or supplies, a loss deduction may be appropriate. This could occur when a cash method taxpayer has extended credit to customers for goods delivered and does not eventually receive payment. However, the amount of the bad debt deduction for the cash method taxpayer is limited to the taxpayer's cost in acquiring those goods.

### Car and Truck Expense

In mobile food vending businesses it is common for taxpayers to incur vehicle expenses. Some of the taxpayers examined also included in this expense their personal car expenses. They claimed the use of their personal vehicle to pick-up supplies, attend meetings, etc.

The frequency of adjustments to this category of expenses is high. While some business expense is almost always incurred, many of the taxpayers fail to keep any records and base their deductions on estimates. No unique industry situations were encountered by examiners in the projects, standard procedures may be applied to auditing car and truck expenses.

### Depreciation Expense and IRC Section 179 Deductions

If the taxpayers owned their own vehicle and used it for business, then depreciation is generally allowable. Computers were also claimed under depreciation but the taxpayers were often not able to establish a business relationship or business use of them.

The two major examination issues, as previously noted, are depreciation over shorter than allowable lives, and failure to properly account for capital-type leases.

Procedures needed to detect these issues are no different than would be employed in any business audit situation. At the pre-audit stage, the lack of any depreciation deductions might indicate that property was previously expensed under IRC section 179, or that

a capital lease was being treated as rent deductions. (In the case of espresso vendors, expenses exceeding 10 to 15 percent of total sales would be a good indicator of the latter.)

Many food vendors lack sophistication in tax matters and often times adequate records of assets are not readily available. If third party information is needed, for instance to establish basis, you may be able to contact the supplier directly. The major equipment suppliers should be listed in the yellow pages and the taxpayers generally know where their equipment was purchased. (There are several popular brands of espresso brewing machines and prices can vary widely primarily due to quality.)

Espresso carts are also supplied by some of the same suppliers of brewing equipment and are often custom made. Again, price can vary significantly. On the other hand, there are a number of carpenter entrepreneurs who custom built espresso carts "on the side." This could represent other taxpayers under-reporting income. In addition, it was often found that equipment was purchased via cash, and in some instances was unreported by the espresso vendor. In one instance, the taxpayer located a supplier in British Columbia, Canada, and imported the equipment as used (this can apparently be accomplished quite easily by using the equipment for a very short period of time, and reduces the customs duty substantially). In the case described, however, the taxpayer established the basis in U.S. currency, while the amount shown on the invoice was in fact in Canadian currency (valued some 20 to 25 percent less).

### **Interest Expense**

Expenses in this category generally relate to financing of vehicles or other equipment. Of course, there may also be interest charges on other debt associated with the financing of business activities.

Examiners should ascertain that personal interest is not included in business deductions. If necessary, the interest allocation rules associated with IRC section 163 may be consulted.

### **Rent or Lease Expense**

Mobile catering vendors often store their vehicles at a commissary at night and then load their product the



following morning. A storage fee or rent is usually charged by the commissary.

Espresso vendors are usually charged a rental fee for placing their cart on public or private property. Rent charges vary considerably, and may be a flat fee or a variable fee based on a percentage of gross receipts.

Standard auditing procedures appropriate to the situation may be employed to audit rent expenses. Usually, very limited procedures may be employed and may consist only of a line of questioning to determine the nature of the payments and the basis for their determination.

Variable rents cannot necessarily be relied on as a reasonableness check of the gross receipts. Several instances encountered showed that the taxpayers apparently based their rents on the same amount of income they were reporting on their tax returns, even though there was significant underreported income.

An unusually high relative rent expense may, as previously noted, indicate improper treatment of a capital lease or deduction of personal expenses.

### **Taxes and Licenses**

State sales taxes, where applicable, are the major tax expense to be considered. The customary practice in the areas studied is for the food vendor to post prices on their menu inclusive of state sales taxes.

If the taxpayer has included sales tax received with gross sales, then a deduction for sales taxes is appropriate. Otherwise, (that is: Where gross receipts are reported net of sales taxes) no deduction should be allowable.

Where state sales taxes are involved, it is a good idea to make certain the taxpayers are consistent in their treatment, and that they are in fact paying these monies over to the state. Through the Service's joint efforts with the State Taxing Agencies, it was discovered that a number of vendors who filed tax returns with IRS did not file tax returns with the state taxing agencies. It is also a good idea, where sales are reported on the tax return net of taxes, to reconcile to the taxpayer's books. Sometimes taxpayers report sales net of taxes to their accountant who again nets their figure resulting in a double deduction.

In the examinations conducted under the project, real estate taxes was not an issue. However, as more fixed location espresso businesses come into existence, it is possible that real property taxes may be encountered in future examinations. Other taxes, such as local business, occupation taxes, and personal property taxes may be applicable, but these are generally *de minimis*.

Routine audit procedures should be employed as warranted.

### **Wages and Salaries Expense**

No special techniques are required with respect to this issue. Conventional auditing techniques appropriate to the situation may be used. As noted previously, it is virtually impossible to operate an espresso business in any form without some hired labor, and this is also often the case for mobile catering vendors. In most smaller businesses, wages are low and no benefits are provided.

As with many small, cash intensive businesses, there is risk of "under the table" payments for labor. If the taxpayer claims the expense on the tax return and can substantiate the expense then a deduction is allowable. Otherwise, no deduction is allowable. Situations where no salaries, wages, or other payments for labor are reported should be investigated.

Although payrolls may often be relatively small, it is simple work to reconcile the payrolls. Due to the lack of taxpayer sophistication, there is likely to be a greater incidence of error in the reporting and deduction of wages and payroll taxes.

Once it has been determined that the taxpayer is entitled to deduct the expense, the examiner should ensure that the proper information returns and/or employment tax returns have been filed. Even though catering truck cooks should be considered employees based on the 20 common law factors (see Exhibit 5-18), taxpayers frequently do not maintain tax information on employees, such as name, address, or tax identification number. In this event, the taxpayer becomes responsible for the assessment of backup withholding. Information return penalties will also apply if the taxpayer has verified that he or she is entitled to the

wage expense, and tax information was maintained (see additional information in the sections on Employment Taxes, Back-up Withholding, and Penalties).

### Home Office Deduction

Taxpayers may claim a deduction for use of their home for business, and the rules of IRC section 280A will be applicable. Basically, within the mobile food industry, the mere fact that these businesses work out of a vehicle or do not have a fixed business location, would indicate that they must conduct a percentage of their business out of their residence. However, a home office deduction is available only if the taxpayer meets the requirements of regular and exclusive use under IRC section 280A(c)(1) and meets the comparative analysis tests as applied in *Commissioner v. Soliman*, 113 S. Ct. 701 (1993). See Rev. Rul. 94-24, 1994-15 I.R.B. 5; Notice 93-12, 1993-8 I.R.B. 46. Because most of the mobile food industry delivers goods and services at a location other than the home (that is, in the mobile trucks), few taxpayers in this industry will qualify for a home office deduction.

### GAINS AND LOSSES

It is not uncommon for these businesses to sell and replace equipment. Dealers in new espresso equipment seldom deal in used equipment, so most dispositions are to private parties. As previously mentioned, equipment is often expensed under IRC section 179 and most dispositions will result in gains. There is a high frequency of error and omission in this area. Dispositions are usually easy to detect, because the taxpayer acquires and places new equipment in service.

There is also the possibility that a mobile food vendor may sell the entire operating business. It is customary for the seller to ask for a considerable amount for goodwill, especially if operating at a good, high volume location. Again, because taxpayers are often unsophisticated in tax matters, there is a strong possibility that gains are improperly reported or unreported. Although not encountered by the project group, it is probable that sale of the going business may include a covenant not to compete and allocate a substantial part of the sales price accordingly. Particularly in the case of mobile vendors, it would be difficult to justify much if any value for such a covenant. It is not uncommon in the Seattle area to

find several espresso vendors within a few hundred feet of one another. Circumstances where a new business could be located so close to an existing operation as to have any significant economic impact would probably be rare. Whether auditing the seller or buyer of one of these operations, it is probably a good idea to check the other side of the transaction for consistency of treatment.

When examining the treatment of purchased businesses, the impact of *Newark Morning Ledger v. United States*, 113 S. Ct. 1670 (1993), and IRC section 197 on the treatment of amounts allocated to goodwill and other intangibles should be considered. Since goodwill may now be amortized and a covenant not to compete must be amortized over 15 years, the significance now lies more in whether a proper allocation of purchase price has been made by buyer and seller. This is a valuation issue which impacts on the basis used by the buyer for individual assets purchased with the business. An excessive allocation to a transferrable business asset will limit gain if that asset is resold and can lead to excessive depreciation or amortization deductions if the asset is retained in the business.

Finally, mobile food vendor businesses may be marketed as "package deals" and a host of potential issues may be present. If this situation is encountered, it is advisable to employ whatever procedures are necessary to assure the transactions are treated appropriately on the tax returns. The issue is not about someone selling a business they have been operating, but rather about a trade or business conducted to market new businesses.

In examining such transactions, one must look for the possibility of franchise issues, involving IRC section 1253 for years that predate the effective date (retroactive to 1991 if elected) of IRC section 197. Franchises are also now the subject of IRC section 197 amortization and taxpayers may elect to apply the provisions of IRC section 197 to all property acquired after July 25, 1991.

#### SUMMARY

As you have no doubt concluded, the mobile food vendor business is relatively simple and straightforward. In most instances it requires little in the way of sophisticated audit techniques.

The issue with the most significant audit potential, the underreporting of gross income, can be examined relatively easily by employing estimation techniques. A general understanding of the industry coupled with the understanding of the relationship between costs and potential profits are the keys to audit efficiency and the detection of underreported income where it exists.

**TECHNICAL DISCUSSION OF INCOME RECONSTRUCTION  
(INDIRECT METHODS AND ESTIMATIONS)**

**ISSUE:** Whether the taxpayer has properly reflected his or her income based on documentation presented or the lack thereof.

**FACTS:** Taxpayers in the food industry generally operate on a cash basis, meaning they report income based on cash received and expenses based on amounts paid. A problem with this habit arises when the taxpayer does not maintain adequate records which properly reflect income. Basically, taxpayers in this industry provide documentation for purchases only. There is often no corresponding documentation which clearly reflects income; therefore, it is necessary to use an indirect method in determining the taxpayers gross income. The most effective method would be the percentage of markup method; however, depending on information available from taxpayers, the bank deposit analysis or the cash transaction analysis could also be effective.

**LAW:** IRC section 446(b) states, "Where a taxpayer keeps no books or records, or his records are inadequate, the IRS has statutory authority to compute income in accordance with whatever method will, in the IRS's opinion, clearly reflect the taxpayers income." The IRS has developed several methods of reconstructing income. Three of these methods were utilized during the audits of this industry: Bank deposit analysis, cash and disbursements, and percentage of mark-up.

Authority to use an indirect method does not come without some burden being placed upon the IRS. The method determined must be reasonable, otherwise the courts may rule in favor of the taxpayer as long as they have provided proof of their dispute against the government.

In *Michael R. Kelly v. Commissioner*, No. 30915-84 (T.C. Memo. 1987), the tax courts ruled in favor of the IRS in the reconstruction of income based on the bank deposit analysis. The taxpayer made no

attempts to refute the additional income determined by the IRS, therefore, additional income was assessed. The bank deposit analysis is a long accepted method of determining income based on reconstruction. See also *Nicholas v. Commissioner* (Dec. 35,430), 70 T.C. 1057,1065 (1978); *Estate of Mason v. Commissioner* (Dec. 33,349), 64 T.C. 651,653 (1975), *aff'd* (78-1 U.S.T.C. 9162) 566 F.2d 2 (6th Cir. 1977).

In *Joseph Bozied and Mildred Bozied v. Commissioner*, 28 T.C.Memo. 740, Dec. 29,658 (M), T.C. Memo. 1969-142, although the taxpayer tried to refute the bank deposit analysis by claiming that a loan existed, lack of adequate documentation to verify the loan will be held in the Government's favor. An error was found to exist on the part of the Government in the calculation of the taxpayers income. The adjustment, however, was not in the calculation of gross receipts using a bank deposit analysis, but in the calculation of cost of goods sold. The taxpayer provided cancelled checks to verify purchases not originally claimed on the return.

In *David Rosenberg V. Commissioner*, Dec. 46,687 (M), T.C. Memo. 1990-328, the Government determined based on the cash transaction analysis, that there was an understatement of income. The Government's responsibility is to provide adequate documentation which establishes the source of income. In the cash transaction analysis, additional unreported income is dependent on the outflow side of the equation. The computation, unexplained, does not automatically identify the omitted income as being gross receipts. You must prove that the omission was from gross receipts. In this case, the respondent (the Government), had to prove: 1) that the understatement was not from overstated deductions in the outflow side, and 2) that it was not from nontaxable sources of income. This is why it is extremely important to verify the accuracy of the personal living statement in the presence of the taxpayer, and tie down any nontaxable sources of income at the very beginning of the audit.

In *Russell A. Bufalino and Carolyn Bufalino v. Commissioner*, Dec. 33,758 (M), T.C. Memo. 1976-110, an adjustment was made by the courts in unreported income due to the unreasonableness of the determined living expenses. So, you must be reasonable in your determination of expenses, especially personal living expenses. In the Rosenberg case, the courts concluded that the respondent has established unreported sales receipts as a likely source of the cash transaction analysis imbalance.

The final indirect method used to determine unreported income was the percentage of mark-up. In *Armando DiLando and Josephine DiLando v. Commissioner*, Dec. 33,342 (M), T.C. Memo. 1975-243, the percentage of mark-up method was approved in determining unreported income. The respondent concluded and accepted the cost of goods sold as reported on the taxpayer's tax return, thereby determining that income should exceed cost of goods sold by 40 percent. He determined this amount from two different sources: 1) statistical survey prepared by the National Cash Register Co. which supported the 40 percent mark-up, and 2) from information supplied by the taxpayer which showed that the gross sales exceeded cost of goods sold by 40 percent. When using this method other evidence should be considered. If you are using a statistical study, consider whether it clearly applies to the taxpayers situation. Many statistics are based on ideal situations. However, there are some circumstances which can affect the reality of your particular taxpayers situation, such as a taxpayer operating his business by offering cash discounts to customers for multiple purchases, areas they service which could not afford the average price, or an unpopular route. All these can determine whether the statistical information should be considered or whether other considerations should be made.



**CONCLUSION:** When using an indirect method for determining gross receipts, select a method which is reasonable. For businesses dealing strictly in cash transactions, a bank deposit analysis is not an effective method. However, if the business receives the majority of income in checks, a bank deposit analysis could be effective. The average markup combined with an indirect method such as the cash transaction or bank deposit analysis can be used as a guide in determining the taxpayer's gross income. This establishes more credibility on the part of the Government with the courts.

**Exhibit 5-2**

Taxpayer: \_\_\_\_\_ TA's Initials \_\_\_\_\_

\_\_\_\_\_ Form 1040 Date Prepared \_\_\_\_\_

**Simplified Bank Deposit Analysis**

	Per Return	Per Audit	Adjustment
	=====	=====	=====

Issue: Recompute gross income using indirect method (Simplified Bank Deposit Analysis) as authorized per IRC section 446(b).

Analysis: W/P Ref

Total Deposits: (see w/p for bank info.)

1. \_\_\_\_\_
2. \_\_\_\_\_
3. \_\_\_\_\_
4. \_\_\_\_\_
5. \_\_\_\_\_

Total Deposits \$ \_\_\_\_\_

Less Non-Taxable Items

- Redeposits \_\_\_\_\_
- Loans Received \_\_\_\_\_
- Transfers In \_\_\_\_\_
- Cash Withdraws \_\_\_\_\_
- All Others \_\_\_\_\_
- Total Nontaxable Items ( \_\_\_\_\_ )

**Net Deposits** \$ \_\_\_\_\_

Total Outlays

- Sch. C Business Exp. \_\_\_\_\_
- Less: Depr. Exp. ( \_\_\_\_\_ )
- Decr. Inv. Bal. ( \_\_\_\_\_ )
- Add: Incr. Inv. Bal. \_\_\_\_\_
- Net Sch C Bus Exp \$ \_\_\_\_\_
- Personal Living Exp(F. 4822) \_\_\_\_\_
- Loans Repaid \_\_\_\_\_
- Assets Purchased \_\_\_\_\_
- Other Expenses \_\_\_\_\_
- Total Outlays \$ \_\_\_\_\_
- Less: Total Checks Written ( \_\_\_\_\_ )

**Cash Expenditures** \$ \_\_\_\_\_

**Corrected Gross Income(Net Deposits + Cash Expenses)** \$ \_\_\_\_\_

Less: Income per tax return

- Wages \$ \_\_\_\_\_
- Sch B Int & Div \_\_\_\_\_
- Sch C Gross Income \_\_\_\_\_
- Sch D Stock Sales \_\_\_\_\_
- Sch E Supplemental Income \_\_\_\_\_
- Other Sources of Reported Income \_\_\_\_\_
- Total Income Per tax Return \_\_\_\_\_

Understatement of Income (Cash Basis) ( \_\_\_\_\_ )

\$ \_\_\_\_\_

=====

Conclusion: w/p \_\_\_\_\_

This page intentionally left blank.

Exhibit 5-3

**Taxpayer:** \_\_\_\_\_  
\_\_\_\_\_ Form 1040

TA's initials \_\_\_\_\_  
Date Prepared \_\_\_\_\_

**Procedure:** Prepare a list of all business and personal bank accounts maintained by taxpayer during calendar year.

**Analysis:**

**Bank** Ref. Number                      Bank Information

Bank Name:  
1 Bank Address:  
Bank Telephone:  
Account Type:  
Account Number:

Bank Name:  
2 Bank Address:  
Bank Telephone:  
Account Type:  
Account Number:

Bank Name:  
3 Bank Address:  
Bank Telephone:  
Account Type:  
Account Number:

Bank Name:  
4 Bank Address:  
Bank Telephone:  
Account Type:  
Account Number:

Bank Name:  
5 Bank Address:  
Bank Telephone:  
Account Type:  
Account Number:

w/p \_\_\_\_\_

This page intentionally left blank.

Taxpayer: \_\_\_\_\_  
 \_\_\_\_\_ Form 1040

TA's Initials \_\_\_\_\_  
 Date Prepared \_\_\_\_\_

**TOTAL DEPOSITS DURING THE YEAR**

**Procedure:** Prepare a list of deposits for all bank accounts maintained during the year. (\* = see w/p \_\_\_\_\_ for bank information)

**Analysis:**

	*	*	*	*	*
Month	1	2	3	4	5
January	---	---	---	---	---
February	---	---	---	---	---
March	---	---	---	---	---
April	---	---	---	---	---
May	---	---	---	---	---
June	---	---	---	---	---
July	---	---	---	---	---
August	---	---	---	---	---
September	---	---	---	---	---
October	---	---	---	---	---
November	---	---	---	---	---
December	---	---	---	---	---
<b>Total</b>	---	---	---	---	---

**ADD**

Deposits in Transit @ 12/31 \_\_\_\_\_

Less.

Deposits in Transit @ 1/1 \_\_\_\_\_

**Total Deposits** \_\_\_\_\_

**Beg. Bal. @ 1/1** \_\_\_\_\_

**End. Bal. @ 12/31** \_\_\_\_\_

w/p \_\_\_\_\_

This page intentionally left blank.

**Exhibit 5-5**

**Taxpayer:** \_\_\_\_\_ TA's Initials \_\_\_\_\_  
 \_\_\_\_\_ Form 1040 Date Prepared \_\_\_\_\_

**TOTAL CHECKS WRITTEN DURING THE YEAR**

**Procedure:** Prepare a list of checks written from all bank accounts maintained during the year.  
 (\* = see w/p \_\_\_\_\_ for bank information)

**Analysis:** \_\_\_\_\_

Month	1	2	3	4	5
January	- - - -	- - - -	- - - -	- - - -	- - - -
February	- - - -	- - - -	- - - -	- - - -	- - - -
March	- - - -	- - - -	- - - -	- - - -	- - - -
April	- - - -	- - - -	- - - -	- - - -	- - - -
May	- - - -	- - - -	- - - -	- - - -	- - - -
June	- - - -	- - - -	- - - -	- - - -	- - - -
July	- - - -	- - - -	- - - -	- - - -	- - - -
August	- - - -	- - - -	- - - -	- - - -	- - - -
September	- - - -	- - - -	- - - -	- - - -	- - - -
October	- - - -	- - - -	- - - -	- - - -	- - - -
November	- - - -	- - - -	- - - -	- - - -	- - - -
December	- - - -	- - - -	- - - -	- - - -	- - - -
<b>Total</b>	- - - -	- - - -	- - - -	- - - -	- - - -

**Add:**

**Outstanding** checks @ 12/31\_ - - - - - - - - - -

**Less:**

**Outstanding** checks @ 1/1 - - - - - - - - - -

**Total Checks** - - - - - - - - - -

**Beg. Bal.** @ 1/1 - - - - - - - - - -

**End. Bal.** @ 12/31 - - - - - - - - - -

w/p \_\_\_\_\_



This page intentionally left blank.

Taxpayer: \_\_\_\_\_

TA's Initials \_\_\_\_\_

\_\_\_\_\_ Form 1040

Date Prepared \_\_\_\_\_

---

**LIST OF NONTAXABLE DEPOSITS**

---

**Procedure:** Prepare a list of non-taxable deposits into all bank accounts maintained during the year.  
 (\* = see w/p for bank information)

**Analysis:**

Deposit	*	*	*	*	*
Description	1	2	3	4	5
	Date	Date	Date	Date	Date
Redeposit Checks	- - - -	- - - -	- - - -	- - - -	- - - -
Loans Received	- - - -	- - - -	- - - -	- - - -	- - - -
Transfers In	- - - -	- - - -	- - - -	- - - -	- - - -
Cash Withdraws	- - - -	- - - -	- - - -	- - - -	- - - -
All Other	- - - -	- - - -	- - - -	- - - -	- - - -

w/p \_\_\_\_\_

This page intentionally left blank.

Exhibit 500-1

(4-23-81)

Markup Table

Margin Percent of <u>Selling Price</u>	Markup Percent of <u>Cost</u>	Margin Percent of <u>Selling Price</u>	Markup Percent of <u>Cost</u>
4.8	5.0	25.0	33.3
5.0	5.3	26.0	35.0
6.0	6.4	27.0	37.0
7.0	7.5	27.3	37.5
8.0	8.7	28.0	39.0
9.0	10.0	28.5	40.0
10.0	11.1	29.0	40.9
10.7	12.0	30.0	42.9
11.0	12.4	31.0	45.0
11.1	12.5	32.0	47.1
12.0	13.6	33.3	50.0
12.5	14.3	34.0	51.5
13.0	15.0	35.0	53.9
14.0	16.3	35.5	55.0
15.0	17.7	36.0	56.3
16.0	19.1	37.0	58.8
16.7	20.0	37.5	60.0
17.0	20.5	38.0	61.3
17.5	21.2	39.0	64.0
18.0	22.0	39.5	65.5
18.5	22.7	40.0	66.7
19.5	23.5	41.0	70.0
20.0	25.0	42.0	72.4
21.0	26.6	42.8	75.0
22.0	28.2	44.4	80.0
22.5	29.0	46.1	85.0
23.0	29.9	47.5	90.0
23.1	30.0	48.7	95.0
24.0	31.6	50.0	100.0

This page intentionally left blank.

(SAMPLE GRID)

ESPRESSO CART  
COST/PROFIT PROJECTION

TYPE OF DRINK	RATIO OF SALES	COSTS						SALES		PROFIT	
		COFFEE	MILK	FLAVORS	CUP/LID NAPKIN	TOTAL	WEIGHTED AVERAGE	PRICE	WEIGHTED AVERAGE	GROSS	WEIGHTED AVERAGE
ESPRESSO	S 1.50%	0.08	0.00	0.00	0.08	0.16	0.002	\$1.00	0.015	\$0.84	0.013
	D 1.50%	0.16	0.00	0.00	0.08	0.24	0.004	\$1.25	0.019	\$1.01	0.015
AMERICANO	S 2.50%	0.08	0.00	0.00	0.08	0.16	0.004	\$1.50	0.038	\$1.34	0.034
	D 2.50%	0.16	0.00	0.00	0.08	0.24	0.006	\$1.75	0.044	\$1.51	0.038
CAPPUCCINO	S 2.50%	0.08	0.10	0.00	0.08	0.26	0.007	\$1.50	0.038	\$1.24	0.031
	D 2.50%	0.16	0.10	0.00	0.08	0.34	0.009	\$1.75	0.044	\$1.41	0.035
CAFFE LATTE	S 37.50%	0.08	0.10	0.00	0.08	0.26	0.098	\$1.50	0.563	\$1.24	0.465
	D 37.50%	0.16	0.10	0.00	0.08	0.34	0.128	\$1.75	0.656	\$1.41	0.529
CAFFE MOCHA	S 2.50%	0.08	0.10	0.05	0.08	0.31	0.008	\$1.75	0.044	\$1.44	0.036
	D 2.50%	0.16	0.10	0.05	0.08	0.39	0.010	\$2.00	0.050	\$1.61	0.040
FLAVORED LATTE	S 3.50%	0.08	0.10	0.12	0.08	0.38	0.013	\$1.75	0.061	\$1.37	0.048
	D 3.50%	0.16	0.10	0.12	0.08	0.46	0.016	\$2.00	0.070	\$1.54	0.054
	100.00%						0.303		1.640		1.337
	=====						=====		=====		=====
							18.47%		100.00%		81.53%

S = SINGLE SHOT

D = DOUBLE SHOT

ASSUMPTIONS:

COST OF COFFEE: COST PER POUND = \$4.80; YIELD = 60 SHOTS PER POUND

COST OF MILK: SERVING = 6 OZ. PER DRINK; COST = \$2.00 PER GALLON

COST OF FLAVORS: BASED ON INDUSTRY SUPPLIER ESTIMATE

COST OF CUP, LID, NAPKIN: CUP = .05; LID = .025; NAPKIN = .005

SALES MIX RATIOS ARE ESTIMATED

This page intentionally left blank.

(SAMPLE)

REVENUE ESTIMATE  
COFFEE SALES  
BASED ON COFFEE CONSUMPTION

BEGINNING INVENTORY	30	(POUNDS)
PURCHASES	1500	(POUNDS)
LESS ENDING INVENTORY	-30	(POUNDS)
	-----	
TOTAL COFFEE USED	1500	(POUNDS)
LESS BULK SALES/PERSONAL USE	-20	(POUNDS)
	-----	
NET USED IN PRODUCTION	1480	(POUNDS)
TIMES YIELD PER POUND	60	(SHOT FACTOR)
	-----	
TOTAL SHOTS PRODUCED	88800	
DIVIDED BY SHOTS PER DRINK	1.5	(ESTIMATE OR COMPUTE)
	-----	
ESTIMATED DRINKS PRODUCED	59200	
LESS FREE DRINKS	-2960	(ESTIMATE)(5 percent)
LESS SPILLAGE, ETC.	-592	(ESTIMATE)(1 percent)
	-----	
NET NUMBER OF DRINKS SOLD	55648	
AVERAGE SELLING PRICE	1.64	(ESTIMATE OR COMPUTE)
	-----	
ESTIMATED REVENUE	91262.72	(NOTE A)
	=====	

NOTE A: IF SALES TAXES ARE INCLUDED IN AVERAGE SELLING PRICE,  
THIS FIGURE MUST BE DIVIDED BY ONE PLUS THE TAX RATE  
TO DETERMINE THE TAXABLE AMOUNT.



This page intentionally left blank.

( SAMPLE )

DATA GRID

TYPE OF DRINK	SELLING PRICE		QTY PER 100 SALES		REVENUE	QTY CUPS USED
	SINGLE	DOUBLE	SINGLE	DOUBLE		
ESPRESSO	\$1.00	\$1.25	2	3	\$5.75	5
AMERICANO	\$1.25	\$1.50	2	4	\$8.50	12
CAPPUCCINO	\$1.25	\$1.50	2	3	\$7.00	5
CAFFE LATTE	\$1.50	\$1.75	15	30	\$75.00	45
CAFFE MOCHA	\$1.75	\$2.00	3	5	\$15.25	8
FLAVORED LATTE	\$1.75	\$2.00	10	15	\$47.50	25
OTHER	\$2.00	\$2.50	2	4	\$14.00	6
			----	----	-----	-----
			36	64	\$173.00	106.00
					100	100
					-----	-----
AVG SELLING PRICE/CUPS PER SALE					\$1.73	1.06
					=====	=====

THIS GRID DEPICTS A SAMPLE FORMAT WHICH MAY BE USED TO OBTAIN AND CALCULATE BASELINE DATA FOR PROJECTING REVENUE.

THE EXAMPLE ASSUMES ALL DRINKS ARE SINGLE CUPPED, EXCEPT AMERICANO WHICH IS DOUBLE CUPPED.

This page intentionally left blank.

( SAMPLE )

SUGGESTED FORMAT  
FOR SCHEDULING  
COFFEE PURCHASES

SUPPLIER NAME:  
SUPPLIER ADDRESS:  
GL ACCT. NUMBER:

DATE	INVOICE NUMBER	INVOICE AMOUNT	CHECK NUMBER	CHECK AMOUNT	POUNDS PURCHASED
-----					

-----					
TOTAL		0 =====		0 =====	0 =====

NOTE: BY HEADING UP A WORKPAPER SIMILAR TO THE ABOVE, YOU MAY ENLIST THE TAXPAYER'S ASSISTANCE IN SCHEDULING DATA FROM THE ORIGINAL INVOICES. YOU CAN THEN FOOT THE COLUMNS AND TEST ACCURACY OF THE DATA BY SAMPLING SEVERAL INVOICES AND COMPARING TO THE ENTRIES PREPARED BY THE TAXPAYER.

This page intentionally left blank.

(SAMPLE)

REVENUE ESTIMATE  
COFFEE SALES  
BASED ON CUP CONSUMPTION

<b>BEGINNING</b>		
INVENTORY	1	(CASES)
PURCHASES	75	(CASES)
LESS ENDING INVENTORY	-1	(CASES)
	-----	
TOTAL CUPS USED	75	(CASES)
QUANTITY PER CASE	1000	(NOTE B)
	-----	
NET USED IN PRODUCTION	75000	(NOTE C)
LESS FREE DRINKS	-3750	(ESTIMATE)(5 percent)
LESS SPILLAGE, ETC.	-1500	(ESTIMATE)(2 percent)
	-----	
ESTIMATED NUMBER OF DRINKS SOLD	69750	
AVERAGE SELLING PRICE	1.64	(ESTIMATE OR COMPUTE)
	-----	
ESTIMATED REVENUE	114390	(NOTE A)
	=====	

NOTE A: IF SALES TAXES ARE INCLUDED IN AVERAGE SELLING PRICE, THIS FIGURE MUST BE DIVIDED BY ONE PLUS THE TAX RATE TO DETERMINE THE TAXABLE AMOUNT.

NOTE B: THE TYPICAL CASE PACK IS USUALLY 1000, BUT VENDORS MAY ON OCCASION PURCHASE IS PART CASES, OR IN SLEEVES OF 50 OR 100.

NOTE C: A SIMILAR ESTIMATE MAY BE MADE BASED ON THE NUMBER OF LIDS CONSUMED (BUT KEEP IN MIND THAT NOT ALL DRINKS ARE SOLD WITH LIDS.)

THIS ESTIMATING TECHNIQUE CAN BE FURTHER COMPLICATED WHERE THE VENDOR USES PLASTIC CUPS FOR COLD DRINKS, BUT THE TYPES OF CUPS USED ARE EASILY IDENTIFIABLE BY REFERENCE TO THE PURCHASE INVOICE. ALSO, WHILE 8 OZ. AND 16 OZ. HOT DRINK CUPS ARE COMMONLY USED, MOST HOT DRINKS ARE SOLD IN 12 OZ. CUPS.

This page intentionally left blank.

(SAMPLE)

**SUGGESTED FORMAT  
FOR SCHEDULING  
CUP/LID PURCHASES**

**SUPPLIER NAME :**  
**SUPPLIER ADDRESS :**  
**GL ACCT. NUMBER :**

DATE	INVOICE NUMBER	INVOICE AMOUNT	CHECK NUMBER	CHECK AMOUNT	8 OZ	HOT CUPS 12 OZ	16 OZ	COLD CUPS	HOT LIDS	COLD LIDS											
----- (QUANTITIES) <tr> <td>TOTAL</td> <td></td> <td>0 =====</td> <td></td> <td>0 =====</td> <td>0 =====</td> <td>0 =====</td> <td>0 =====</td> <td>0 =====</td> <td>0 =====</td> <td>0 =====</td> </tr>											TOTAL		0 =====		0 =====	0 =====	0 =====	0 =====	0 =====	0 =====	0 =====
TOTAL		0 =====		0 =====	0 =====	0 =====	0 =====	0 =====	0 =====	0 =====											

NOTE: BY HEADING UP A WORKPAPER SIMILAR TO THE ABOVE, YOU MAY ENLIST THE TAXPAYER'S ASSISTANCE IN SCHEDULING DATA FROM THE ORIGINAL INVOICES. YOU CAN THEN FOOT THE COLUMNS AND TEST ACCURACY OF THE DATA BY SAMPLING SEVERAL INVOICES AND COMPARING TO THE ENTRIES PREPARED BY THE TAXPAYER.



This page intentionally left blank.

(SAMPLE)

REVENUE ESTIMATE  
 ITALIAN SODAS  
 BASED ON SYRUP CONSUMPTION

<b>BEGINNING</b>		
INVENTORY	20	(BOTTLES)
PURCHASES	1000	(BOTTLES)
LESS ENDING INVENTORY	-30	(BOTTLES)
	-----	
TOTAL SYRUP USED	990	(BOTTLES)
LESS BULK SALES/PERSONAL USE	-20	(BOTTLES)
	-----	
NET USED IN PRODUCTION	970	(BOTTLES)
TIMES YIELD PER BOTTLE	13	(NOTE A)
	-----	
TOTAL DRINKS PRODUCED	12610	
LESS FREE DRINKS	-252.20	(ESTIMATE) (2%)
LESS SPILLAGE, ETC.	-252.20	(ESTIMATE) (2%)
	-----	
ESTIMATED NUMBER OF DRINKS SOLD	12105.60	
AVERAGE SELLING PRICE	1.65	(ESTIMATE OR COMPUTE)
	-----	
ESTIMATED REVENUE	19974.24	(NOTE B)
	=====	

NOTE A: BASED ON 26 OZ. BOTTLES; 2 OZ SERVING PER DRINK.

NOTE B: IF SALES TAXES ARE INCLUDED IN AVERAGE SELLING PRICE, THIS FIGURE MUST BE DIVIDED BY ONE PLUS THE TAX RATE TO DETERMINE THE TAXABLE AMOUNT.

This page intentionally left blank.

(SAMPLE)

SUGGESTED FORMAT  
FOR SCHEDULING  
SYRUP PURCHASES

SUPPLIER NAME:  
SUPPLIER ADDRESS:  
GL ACCT. NUMBER:

DATE	INVOICE NUMBER	INVOICE AMOUNT	CHECK NUMBER	CHECK AMOUNT	CASES	SINGLE BOTTLES	OTHER	OTHER
-----								
-----								
TOTAL		0		0	0	0	0	0
		=====		=====	=====	=====	=====	=====

NOTE: BY HEADING UP A WORKPAPER SIMILAR TO THE ABOVE, YOU MAY ENLIST THE TAXPAYER'S ASSISTANCE IN SCHEDULING DATA FROM THE ORIGINAL INVOICES. YOU CAN THEN FOOT THE COLUMNS AND TEST ACCURACY OF THE DATA BY SAMPLING SEVERAL INVOICES AND COMPARING TO THE ENTRIES PREPARED BY THE TAXPAYER.

"OTHER" COLUMNS MAY BE USEFUL TO SCHEDULE OTHER ITEMS PURCHASED FROM THE SUPPLIER, SUCH AS SELTZER, SOFT DRINKS, ETC.

This page intentionally left blank.

(SAMPLE)

REVENUE ESTIMATE  
COFFEE SALES  
BASED ON MILK CONSUMPTION

BEGINNING INVENTORY	0	(GALLONS)
PURCHASES	2800	(GALLONS)
LESS ENDING INVENTORY	0	(GALLONS)
	-----	
TOTAL MILK USED	2800	(GALLONS)
OUNCES PER GALLON	128	
	-----	
NET USED IN PRODUCTION	358400	(OUNCES)
DIVIDE BY AVERAGE OUNCES PER DRINK	6.00	(ESTIMATE OR COMPUTE)
	-----	
ESTIMATED MILK DRINKS PRODUCED	59733.33	(OUNCES)
LESS FREE DRINKS	-2986.67	(ESTIMATE)(5%)
LESS SPILLAGE, ETC.	-1194.67	(ESTIMATE)(2%)
	-----	
ESTIMATED MILK DRINKS SOLD	55552.00	
DIVIDE BY RATIO OF MILK BASED DRINKS	0.92	(ESTIMATE OR COMPUTE)
	-----	
ESTIMATED TOTAL DRINKS SOLD	60382.61	
AVERAGE SELLING PRICE	1.64	(ESTIMATE OR COMPUTE)
	-----	
ESTIMATED REVENUE	99027.48	(NOTE A)
	=====	

NOTE A: IF SALES TAXES ARE INCLUDED IN AVERAGE SELLING PRICE, THIS FIGURE MUST BE DIVIDED BY ONE PLUS THE TAX RATE TO DETERMINE THE TAXABLE AMOUNT.

This page intentionally left blank.

(SAMPLE)

SUGGESTED FORMAT  
FOR SCHEDULING  
MILK PURCHASES

SUPPLIER NAME:  
SUPPLIER ADDRESS:  
GL ACCT. NUMBER:

DATE	INVOICE NUMBER	INVOICE AMOUNT	CHECK NUMBER	CHECK AMOUNT	GALLONS	HALF GALLON	QUART	PINT
------	-------------------	-------------------	-----------------	-----------------	---------	----------------	-------	------

---

TOTAL	0		0		0		0	0
	=====		=====		=====		=====	=====

NOTE: BY HEADING UP A WORKPAPER SIMILAR TO THE ABOVE, YOU MAY ENLIST THE TAXPAYER'S ASSISTANCE IN SCHEDULING DATA FROM THE ORIGINAL INVOICES. YOU CAN THEN FOOT THE COLUMNS AND TEST ACCURACY OF THE DATA BY SAMPLING SEVERAL INVOICES AND COMPARING TO THE ENTRIES PREPARED BY THE TAXPAYER.



This page intentionally left blank.

**EXPLANATION OF 20 COMMON LAW FACTORS**

- INSTRUCTIONS** A person who is required to comply with instructions about when, where, and how to work is ordinarily an employee. Some employees may work without receiving instructions because they are highly proficient and conscientious workers or because the duties are so simple or familiar to them. Furthermore, the instructions which show how to reach the desired results may have been oral and given only once, sometime in the past.
- TRAINING** Training a person by correspondence, by having an experienced employee work with him or her, or by requiring attendance at a meeting indicates that the employer wants the services performed in a particular manner. Independent contractors ordinarily use their own methods and receive no training from the purchaser of the services.
- INTEGRATION** In applying the integration test, first determine the scope and function of the business and then decide whether the services of the individual are merged into it. When the success and continuation of the business depends to an appreciable degree upon the performance of certain services, the person who performs those services must necessarily be subject to a certain amount of control by the owner of the business.
- SERVICES RENDERED PERSONALLY** If the services must be rendered personally, presumably the employer is interested in the methods as well as the results. Lack of control may be indicated if a person has the right to hire substitutes without the employer's knowledge.
- HIRING SUPERVISING PAYING ASSISTANTS** If an individual hires, supervises, and pays workers at the direction of the employer, the individual may be an employee acting in the capacity of a foreman for a representative of the employer.
- In some instances, although the employer may claim the worker has the right to hire helpers,

good judgment dictates that it would be impossible or impractical. For example, why would a salesperson work for a commissioned salesperson when he or she could work for the employer and not have to split a commission?

**CONTINUING  
RELATIONSHIPS**

A continuing relationship between an individual and the person for whom he or she performs services, indicates that an employer-employee relationship exists. Continuing services may include work performed at frequently recurring though somewhat irregular intervals, either on call of the employer or whenever the work is available. If the arrangement contemplates continuing or recurring work, the relationship is considered permanent even though the services are part time or seasonal or of a short duration.

**SET HOURS  
OF WORK**

The establishment of set hours of work by the employer is a factor indicating control. This condition bars the workers from being in control of their own time, which is the right of independent contractors. If the nature of the occupation makes fixed hours impractical, a requirement that workers be on the job at certain times is an element of control. Sales work often falls into this category, since the sales people must regulate their hours to correspond with the hours of the potential customer.

**FULL TIME  
REQUIRED**

If workers must devote full time to the business of the employer, they are restricted from doing other work. On the other hand, independent contractors are free to work when and for whom they choose. Full time does not necessarily mean an 8-hour day or a 5 day or 6 day week. Its meaning may vary with the intent of the parties and the nature of the occupation. Full-time services may be required even though not specified orally or in writing. In some instances, do not place too much weight on the statement that workers are not required to work full time and may work for others. The workers may be required to produce a minimum volume of business, and thus be compelled to work full time; or in order to earn a living, they must work full time.

**DOING WORK  
ON THE  
EMPLOYER'S  
PREMISES**

Doing the work on the employer's premises implies that the employer has control, especially if the work could be done elsewhere. A person working in the employer's place of business, using his or her desk, telephone, and clerical help, is physically within the employer's direction and supervision, while work done off the premises indicates some freedom from control. Often the employer will point to the fact that the worker is not an employee. There is control when the employer has the right to direct a person to travel a designated route, to canvas a territory, service individuals in a specified area, or work at specified places at certain times. In some occupations, services must be performed away from the premises of the employer; for example, salespersons, taxicab drivers, and employees of construction contractors.

**ORDER OR  
SEQUENCE  
SET**

The employer has control if the workers are not free to follow their pattern of work, but must perform the services in the order or sequence set by the employer. However, because of the nature of an occupation, often an employer does not set the order of the services or sets them infrequently. Outside commissioned salespersons, for example, usually are permitted latitude in mapping out their activities and may work "on their own" to a considerable degree. Perhaps you can gather evidence which shows that the salespersons must report to the office of the employer at specified times, follow up on leads, perform certain services for customers, or perform certain other tasks at certain times.

**ORAL OR  
WRITTEN  
REPORTS**

The requirement that oral or written reports be submitted is an indication of control. However, it is often difficult for the examiner to establish whether reports are required. In some instances both the employer and the worker will state that no report is required although the employer is receiving the necessary reports in a very informal manner. For example, the employer may ask the commissioned salesperson about certain leads if no sales order has been received.

**PAYMENT BY  
HOUR, WEEK**

Payment by the firm of regular amounts at stated intervals to a worker strongly indicates an employer-employee relationship. In such instances, the firm assumes the hazard that the services of the worker will be proportionate to the regular payments. This action warrants the assumption that, to protect its investment, the firm has the right to direct and control the performance of the workers. It is also assumed that workers, by accepting payment upon such basis, have agreed that the firm has the right to control them. Also, workers are assumed to be employees if they are guaranteed a minimum salary or are given a drawing account of a specified amount at stated intervals which need not be repaid when it exceeds earnings.

**PAYMENT OF  
BUSINESS OR  
TRAVELING  
EXPENSES**

If the employer pays the worker's expenses, the worker is ordinarily an employee, since the employer must retain the right to regulate and direct the worker's business activities in order to properly control expenses.

**FURNISHING  
TOOLS AND  
EQUIPMENT**

The fact that an employer furnishes tools and sales aids tends to show the existence of an employer-employee relationship. However, certain skilled workers, such as carpenters, auto mechanics, barbers, and beauticians, customarily furnish their own small tools of their trade. Such practice should be given no weight since it does not indicate a lack of control over the services of the worker.

**SIGNIFICANT  
INVESTMENT**

Lack of investment by a person in facilities or equipment used in performing services for another indicates dependence on the employer and accordingly, the existence of an employer-employee relationship. In general, facilities include equipment or premises necessary for the work, such as office furniture and machinery. The term "significant investment" does not include tools, instruments, and clothing commonly provided by employees in their trade; nor does it include education, experience, or training. Little weight should be given to a worker's investment in equipment if it is not adequate, if it is bought on time from the person for whom the work

is done, or under either circumstances, if the worker's equity in it is small. Also, ascertaining who has the right to control the equipment is significant in determining the weight of the investment factor.

**WORKING FOR  
THAN  
ONE FIRM  
AT A TIME**

An independent contractor is usually free of **MORE** control and may work for a number of persons at the same time. However, it is possible for a person to work for a number of people or firms concurrently and be an employee of one or all of them.

**MAKING  
SERVICES**

You may ascertain whether a worker holds out his or her services to the public by determining the following:

**AVAILABLE TO  
THE GENERAL  
PUBLIC**

1. Does he or she have an office?
2. If the office is in his or her home, is it properly identified by a sign?
3. Does he or she hold business licenses?
4. Is he or she listed in a business directory?
5. Is he or she listed in the yellow pages?
6. Does he or she advertise in a newspaper or trade journal, or on TV or radio?

**RIGHT TO  
DISCHARGE**

The right to discharge is an important factor. Employers may claim they do not have the right to discharge. They probably would not separate good employees for a minor infraction of a rule. However, employers exercise control through the ever-present threat of dismissal, causing the workers to obey instructions, or at least to be diplomatic. On the other hand, self-employed persons cannot be fired so long as they produce a result which measures up to their contract specifications.

**RIGHT TO  
TERMINATE**

Employees have the right to end the relationship with employers at a time they wish without incurring liability. On the other hand, independent contractors agree to complete a specific job, and they are responsible for its satisfactory completion or legally obligated to make good for failure to complete the job.

**REALIZATION  
OF PROFIT  
OR LOSS**

A person who can realize a profit or suffer a loss as a result of his or her services is generally an independent contractor, while the person who cannot is an employee. "Profit or loss" implies the use of capital by a person in an independent business of his or her own. Opportunity of higher earning, such as from pay on a piecework basis or the possibility of gain or loss from a commission arrangement, is not considered profit or loss.

Whether a profit is realized or a loss suffered, generally depends upon management decisions. In other words, the individual responsible for a profit or loss can use ingenuity, initiative, and judgement in conducting the business. The absence of the opportunity for profit or loss may be shown by one or more of a variety of circumstances, such as:

1. The worker cannot hire help, or it would be impractical for either the worker or assistant to do so.
2. The worker does not have his or her own office, equipment, materials, or other work facilities.
3. The worker has no continuing and recurring liabilities or obligations.
4. The worker does not perform specific jobs for prices agreed upon in advance and does not have to pay expenses incurred in connection with the specific jobs.
5. The services performed by the worker do not build or destroy his or her reputation in the community to the degree it affects the reputation of the employer, because the customer is "buying" the services of the employer.

**NOTE:** These factors are an aid in determining whether the service recipient maintains sufficient direction and control over the service provider as to the details and means by which the result is accomplished. In any given case, some factors may be more significant than others and some factors may be irrelevant.

## Chapter 6

### EMPLOYMENT TAXES

#### EMPLOYEE OR INDEPENDENT CONTRACTOR

Generally speaking, whether a worker is an employee or independent contractor depends on the amount of direction and control the firm exercises over the workers who perform the services. Specifically, section 3121(d)(2) of the Internal Revenue Code provides that the term "employee" means any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of employee.

The question of whether an individual is an independent contractor or an employee is to be determined upon consideration of the facts and the application of the law and regulations in a particular case. Guides for determining the existence of that status are found in three substantially similar sections of the Employment Tax Regulations; namely, Treas. Reg. sections 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1 relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding, respectively.

Treas. Reg. section 31.3121(d)-1(c)(2) provides that generally, the relationship of employer and employee exists when the person for whom the services are performed has the right to control and direct the individual who performs the services not only as to the results to be accomplished by the work, but also as to the details and means by which the result is accomplished. That is, an employee is subject to the will and control of the employer not only as what shall be done, but also as to how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which services are performed; it is sufficient if he or she has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is the employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the service. In general, if an individual is subject to the control or direction of another merely



as to the result to be accomplished and not as to the means and methods for accomplishing the result, he or she is an independent contractor.

In determining whether an individual is an employee under the common law rules, a number of factors have been identified as indicating whether sufficient control is present to establish an employer-employee relationship. The factors have been developed based on an examination of cases and rulings considering whether an employee is an individual. The degree of importance of each factor varies depending on the occupation and the factual context in which services are performed. See Rev. Rul. 87-41, 1987-1 C.B. 296.

Treas. Reg. section 31.3121(d)-1(a)(3) provides that if the relationship of an employer and employee exists, the designation or description of the parties as anything other than that of employer and employee is immaterial. Thus, if such relationship exists, it is of no consequence that the employee is designated as a partner, coadventurer, agent, independent contractor, or the like.

**NOTE:** If the worker is classified as an independent contractor, it is possible that he or she may still be an "employee" for FICA purposes only. Under IRC section 3121(d)(3)(A), an employee includes a driver who distributes meat, vegetable, fruit, or bakery products, or beverages (other than milk) or picks up and delivers laundry or dry cleaning, if the driver is an agent or is paid on commission. Any such so-called "statutory employee" will be subject to social security and medicare taxes if:

1. The service contract states or implies that almost all of the services are to be performed personally by the worker(s);
2. The worker has little or no investment in the equipment and property used to perform the services (other than an investment in transportation facilities); and
3. The services are performed on a continuing basis.

The same rule applies to this category of statutory employee for FUTA purposes.

## IRC SECTION 530

IRC section 530 of the Revenue Act of 1978, 1978-3 (Vol. 1) C.B. 1, 119, extended by IRC section 9(d) of Pub.L. 96-167, 1980-1 C.B. 483, 486, and by IRC section 1 of Pub. L. had a reasonable basis for treating their workers as independent contractors.

Generally speaking, IRC section 530 provides that if an employer did not treat an individual as an employee for any period for purposes of the Federal employment taxes, then such individual will be deemed not to be an employee for that period unless the taxpayer had no reasonable basis for not treating the individual as an employee.

To obtain relief under IRC section 530, the taxpayer must have timely filed all required Federal tax returns (including information returns) with respect to an employee for the period on a basis consistent with the employer's treatment of those holding substantially similar positions must have been consistent with the treatment for periods beginning after December 31, 1977.

IRC section 530 lists several so-called "safe-havens" that will constitute a reasonable basis for not treating a worker as an employee. Thus, an employer's reasonable reliance on any of the following safe havens will allow the employer relief under IRC section 530:

1. Judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the employer;
2. A past Internal Revenue Service audit of the employer in which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position held by the individual; and
3. A long-standing recognized practice of a significant segment of the industry in which the individual was engaged.

Furthermore, an employer who fails to meet any of the three safe havens may nevertheless be entitled to IRC section 530 relief if the employer can demonstrate, in some other manner, a reasonable basis for not treating the individual as an employee.

In this regard, you may wish to refer to Rev. Proc. 85-18, 1985-1 C.B. 518.

**NOTE:** It is important to know that relief under IRC section 530, that may be granted to the employee to continue treating the workers as independent contractors, does not change in any way the status, liabilities, and rights of the worker whose status is at issue. It does not convert individuals from the status of employee to the status of self-employed. The worker remains liable for the employee social security and medicare taxes imposed under the Federal Insurance Contributions Act (FICA), but because the employer is not required to withhold income tax, the employee will be required to file estimated tax payments with regard to the wages received from the employer. Furthermore, the worker may not itemize his or her expenses on a Schedule C because the worker is still an employee. The worker's expenses would be reported on Schedule A, and usually subject to the amount in excess of 2 percent of the adjusted gross income.

**NOTE:** An income tax audit of the taxpayer will constitute a prior audit for safe haven purposes. The prior audit does not have to be an employment tax audit. It may be any past Internal Revenue Service audit of the employer in which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position held by the individual.

IRC section 530 was amended by IRC section 1706 of the Tax Reform Act of 1986 by adding IRC section 530(d). Essentially, IRC section 530 relief is not available to a firm that has an arrangement with another person to provide services for such other person. That is, it involves a three-party arrangement, involving a firm, a client for whom the services are performed, and the worker. IRC section 530 will be unavailable to the firm if it misclassified the workers as independent contractors and the workers were, in fact, its employees. Finally, this amendment only applies with regard to services performed by engineers, designers, drafters, computer programmers, systems analysts, or other similarly skilled workers engaged in a similar line of work.

## Chapter 7

### BACK-UP WITHHOLDING

#### INTERNAL REVENUE CODE SECTION 3406

Although backup withholding is not a "penalty," it should be considered in connection with payments made to non-employees or in the case of other payments subject to information reporting. With catering trucks, the taxpayers in the study did not maintain any records as to the payee identification numbers, full name of payee, or addresses of payees. In the majority of the cases, this was neither requested by the taxpayer nor provided by the payee.

Per IRC section 3406, in the case of any reportable payment, if the payee fails to furnish his or her Taxpayer Identification Number (TIN) to the payer in the manner required, or the Secretary notifies the payer that the TIN furnished by the payee is incorrect, then the payer shall deduct and withhold from such payment, a tax equal to 20 percent of such payment (31 percent for amounts paid after December 31, 1992). Reportable payments within this industry include those made for repairs, rents, or commissions subject to regular withholding (IRC section 6041), and payments for remuneration for services (IRC section 6041A (a)). If an individual is subject to backup withholding, **the payer becomes responsible and liable for the tax.**

In most cases, however, the TIN was never requested. This also triggers backup withholding. If payments are substantiated on audit and there is no income tax deficiency, backup withholding should be considered. If payments are not accepted in audit because of a lack of documentation, the primary issue would probably involve a disallowance of the expense on the income tax return. However, backup withholding should be raised as an alternative issue because the taxpayer may be able to support the claimed deduction in Appeals or in court.

Usually in the case of catering trucks, the drivers of the hot trucks will have cooks. They are generally all paid in cash and, therefore, there will likely be no documentation to verify the expense. The drivers often treat them as independent contractors and no information is maintained as to the name, social security number, etc. The amount is usually claimed on the

return as a labor expense or it is not claimed at all. First, determine whether the taxpayer should be entitled to the expense. Then determine if an employer/employee relationship existed. If the persons working for the caterer are actually independent contractors, then the application of backup withholding should be considered.

**NOTE:** Regarding the Assertion of Penalties and Backup Withholding, the penalties under IRC sections 6653 (a), 6653 (b) and 6662 (a) are included with the income tax adjustments (1902-b). The penalties under IRC sections 6652/6721, 6678/6722, 6723, and 6676 are asserted in separate penalty files. The adjustments under IRC section 3406 closely follows the same procedures as additional employment taxes.

#### **ABATEMENT OF BACK-UP WITHHOLDING (IRM 4652)**

IRC section 3402 (d) provides relief from withholding tax for employers in cases where employees have properly reported wages received and paid income tax accordingly. This abatement does not apply under IRC section 3509, Determination of Employer's Liability for Certain Employment Taxes.

In an agreed case, the abatement from withholding tax procedures should be explained to the taxpayer. Forms 4669 and 4670 should be completed and sent directly to the service center.

1. Form 4669 -- Employee Wage Statement
2. Form 4670 -- Request of Relief from Payment of Income Tax Withholding (summary and transmittal statement).

The examiner has no authority to abate withholding taxes. Therefore, an examiner should never accept or request copies of the employees' tax returns to verify an employer's withholding tax abatement claims. (Although the IRM states that Forms 4669 and 4670 should be sent directly to the service center, in practice these forms may be left in the case file with a notation on the Form 3198, Special Handling Notice, for abatement consideration to be given.)

## AIMS PROCEDURES

### Procedures for Asserting Backup Withholding (IRM 4696)

To assert backup withholding, the taxpayer must have an Employer Identification Number (EIN). If they do not have an EIN you must follow these procedures:

1. Complete Form SS-4 and have the taxpayer sign it. Form SS-4 is an application for Employer ID Number. (Complete the following boxes of Form SS-4: Boxes 1, 2, 4a-7, 8a (individual), 9 (other), 10, 12-14, and 16-17c.)

If the taxpayer refuses to sign the form, the examiner should complete the information and sign the form as a representative of the IRS.

2. Contact the AIMS Coordinator for specific instructions.

Once you have followed the procedures for obtaining an EIN, complete Forms 2504, 666, and 4668 to assert backup withholding on your taxpayer.

1. Form 2504 -- Agreement to Assessment and Collection of Additional Tax and Acceptance of Overassessment (Excise or Employment Tax)
2. Form 4666 -- Summary of Employment Tax Audit
3. Form 4668 -- Employment Tax Examination Changes.

Backup withholding should be applied separately to each quarter on the original or substitute Form 941 in which payments were made. However, if payments cannot be traced to a specific quarter, they should be applied to the fourth quarter period of the Form 941. If you had to secure an Employer Identification Number from the service center, then you will follow Substitute for Return Procedures.

### Substitute for Return Procedures (IRM 48(13)1)

Substitute for return procedures must be followed when a taxpayer has not filed appropriate income tax, employment tax or other required returns. Secure transcripts to ensure that returns were not filed. Once it has been determined that Substitute for Return Procedures must be followed, complete the following:

1. For BMF returns with no EIN, follow procedures above for obtaining one through the service center. Submit Form 5345 (Examination Request Master File) to control the case on AIMS. Form 5345 must be completed to close the case. The push code for Substitute for Returns is 021, which should be identified in box 9. In box 11 indicate Form 941. The related activity code for Form 941 is 465, and this goes in box 14. Indicate that the reason for selection is "backup withholding-1099's" in box 17. All other boxes should be self-explanatory.
2. Prepare a Substitute for Return on Form 941. Enter only the following:
  - a. Taxable period shown by year and month, for example 9012.
  - b. Name and current address of taxpayer.
  - c. Employer Identification Number.
  - d. DO NOT enter any dollar amounts.
3. Photocopy the return. Write in bold RED letters across the top of the original return: "Substitute for Return Prepared by Examination Division"
4. If the examination will not be completed within 3 weeks, the following pre-processing package should be completed and sent to the Centralized AIMS as soon as possible (or follow local procedures).
  - a. If you have obtained a Form SS-4 from the taxpayer, staple it to the original "Substitute for Return prepared by Examination Division."
  - b. Send the original Substitute for Return to the AIMS Coordinator, assembled in this order:
    - 1) Form 5345 on top
    - 2) Transcript
    - 3) Document 6469, check "Substitute"
    - 4) Form SS-4, if any
    - 5) Form 3198
    - 6) Original Substitute for Return.

5. Write in bold RED letters across the top of the copy "Substitute for Return Prepared by Examination Division - Original Sent for Processing on\_\_\_\_\_." The copy will be used for case closure.
6. Before closing the case verify that the case is established on AIMS by securing an AMDISA. If the case has been established on AIMS, it is ready to close out of Examination Division. If the case is not established on AIMS, you will need to close the case to the Centralized AIMS Unit (awaiting a TC 150 posting) and establishment on AIMS.
7. A Form 3198 must be attached to the front of the case identifying it as a "Substitute for Return."



This page intentionally left blank.

## Chapter 8

### PENALTY CONSIDERATIONS

#### GENERAL

When auditing the Food Vendors industry, penalties should be considered if the facts and circumstances warrant their application. Because of the nature of the adjustments (unreported income, employment tax issues), auditors should be concerned with the planning and documentation of possible penalties.

#### CRIMINAL FRAUD PENALTY: (IRC SECTION 7201)

If the underreporting of income has proven to be substantial, recurring for 2 or more years, and the taxpayer has no valid explanation as to the understatement, then this opens up the possibility of a criminal fraud referral. Because of the strict criteria used to prove the taxpayer's intention to evade taxes beyond a reasonable doubt, the evidence needed to make a quality referral can be quite extensive.

First, the initial interview must be thorough and must include the appropriate questions as to whether the taxpayer has reported all income from all sources. Questions must be clearly stated to the taxpayer and their responses should be documented as accurately as possible. Follow-up interviews may be needed as the audit progresses.

The evidence of unreported income must be clearly established. This means an accurately and properly documented bank deposit analysis, cash transaction analysis or markup percentage computation. **Documentation of the taxpayer's response to the understatement is very important.**

The taxpayer must be proven as the party ultimately responsible for the tax return. Although this is usually acknowledged by the taxpayer's signature on the return, it is sometimes not enough. In rare instances, the preparers or accountants may indicate that when they prepared the tax return, they may have adjusted the income to reflect what they felt was an accurate figure. Although it would probably occur with the

consent of the taxpayer, it leaves a significant doubt as to the ultimate accountability of the taxpayer.

If possible, try to observe and document all of the taxpayer's dealings in the day-to-day operation of the business. Education levels may also influence taxpayer's level of business sophistication. In these cases, the examiner must prove that the taxpayer is sophisticated enough to understand his or her actions when a substantial amount of income is unreported. Knowing that a taxpayer is sufficiently competent to understand his or her actions and proving it are two different things. Again, it should be emphasized that a thorough initial interview should include information about the taxpayer's educational and business background.

**CIVIL FRAUD PENALTY: (IRC SECTION 6663)**

Since the only difference between criminal fraud and civil fraud is the burden of proof requirement, the same procedures listed above should be followed in developing a civil fraud case. As stated above, a quality referral is based upon a good initial interview, obtaining sufficient evidence, and documenting enough of the taxpayer's actions to prove intent. It should be noted that the 1986 Tax Reform Act modified the civil fraud penalty by increasing the rate to 75 percent. This percentage applies only to the amount of the underpayment attributable to fraud. However, it is the burden of the taxpayer to prove any portion not attributable to fraud.

**ACCURACY-RELATED PENALTY: (IRC SECTION 6662)**

This Code section states that, "\*\*\* if this [penalty] applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies." There are 5 reasons for the assertion of this penalty. They are:

1. Negligence or disregard of rules or regulations.
2. Any substantial understatement of income tax.
3. Any substantial valuation misstatement under Chapter 1.

4. Any substantial overstatement of pension liabilities.
5. Any substantial estate or gift tax valuation understatement.

The two most commonly used are: 1) negligence or disregard of rules or regulations and 2) substantial understatement of income tax. "Negligence" applies when taxpayers have not made any reasonable attempt to comply with the tax laws, and "disregard" applies when taxpayers have proven to be careless and without any regard to rules and regulations. A substantial understatement should be considered when the understatement for the taxable year exceeds the greater of 10 percent of the tax per the return or \$5,000. This penalty should be considered on a case by case basis whenever a taxpayer makes substantial errors in reporting income or when claiming unreasonable or personal deductions which cannot be substantiated by facts.

**FAILURE TO FILE CORRECT INFORMATION RETURNS: (IRC SECTION 6721)**

The general rule of this section provides for a \$50 penalty for each failure to file information return during the calendar year not to exceed \$250,000. In the case where owners of hot catering trucks hire cooks, the requirement of furnishing Forms W-2 or Forms 1099 exists if the \$600 income criteria has been met. You need to establish, based on the 20 common law factors, whether the taxpayer had employees or independent contractors. According to Rev. Rul. 69-624, persons who work as waiters, chefs, and other individuals performing services in connection with the catering business, are deemed to be employees for purposes of FICA, FUTA, and Federal withholding. The relationship of employee/employer exists when the person for whom services are performed has the right to control and direct the individual who performs the services. In the case of the catering trucks this relationship exists. However, auditors have discovered that no names, addresses, or social security numbers were maintained by the taxpayers for the individuals who worked and performed these services. Therefore, the application of this failure to file penalty section applies since employee information was not maintained, filed, nor presented to the auditor during the examination.

**FAILURE TO FURNISH CORRECT PAYEE STATEMENTS (IRC SECTION 6722)**

The general rule of this section provides for a \$50 penalty for each failure to furnish a payee statement or failure to include all required information not to exceed \$100,000 for a calendar year. However, if the payments are for services, in the case of intentional disregard, the penalty increases to 10 percent of the amount required to be reported, or \$100 whichever is greater.

## Chapter 9

### COMPLIANCE 2000

#### GENERAL

It was noted during the examinations that mobile food vendors are often unsophisticated taxpayers. In addition, mobile food vendors (and for that matter similar businesses of a cash intensive nature) are inherently vulnerable to error and abuse particularly with respect to reporting income.

#### COMPLIANCE

The results of the examinations indicated that while mobile vendors constitute a "pocket of noncompliance" as originally anticipated, the degree of noncompliance was not as great as expected. Nonetheless, the knowledge and experience gained as the result of the examinations, coupled with the preparation of this audit industry guide, is a step toward efficient testing and measuring of future compliance. Equally as important, it is hoped that the examinations have and will continue to promote increased compliance both from taxpayers audited and others in the market segment who have become aware of the Service's compliance initiatives. A number of opportunities to better educate taxpayers were encountered during the examinations.

Other divisions (for example, Collection, Criminal Investigations Division (CID), and Appeals) were not impacted significantly as a direct result of examinations conducted on the mobile catering industry. Most of the deficiencies were collected at the time of closing the case by securing full payment or setting up installment agreements. Thus, no special involvement from Collection was needed. Several cases were referred to CID for approval of the civil fraud penalty through routine procedures.

#### UNDERREPORTED INCOME

A number of significant underreported income issues were encountered and settled with the taxpayers' agreement. This accomplishment can be attributed in large part to the concerted efforts of the examiners in

gaining sufficient industry knowledge to detect potential underreported income situations, and in employing reliable and efficient auditing methods to determine adjustments transcending serious rebuttal. Along this line, it is interesting to note that many of the returns examined may well have been surveyed, or inadequate income probes performed, were it not for specific industry knowledge. (For instance, gross profit margins of 50 to 60 percent were commonly indicated based on the face of the tax returns, and this may be viewed as an acceptable range for many food-related businesses. Without the knowledge that gross profit margins for mobile food vendors can easily be in the range of 100 percent, the income issue may be insufficiently addressed.) Underreported income is perhaps the issue most likely leading to unagreed cases in the future, and it is not anticipated that unique or unusual procedures would be warranted. (In fact, with proper development, taxpayers will have difficulty rebutting our gross income determinations.)

#### **SUMMARY**

Another result of the projects is the rapport and communication links established with state and local agencies. It is anticipated that these networks will yield long term benefits to the Service as well as the state and local agencies.

## GLOSSARY

### ACCOUNTING TERMINOLOGY

1. **Accrual Method Of Accounting** --An accounting method where income is reported based on income earned, and expenses are reported as incurred but not necessarily paid.
2. **Cash Method Of Accounting** --An accounting where income is reported when it is actually or constructively received and deductions are taken when they are actually paid.
3. **Hybrid Method Of Accounting** --An accounting method which allows the taxpayer to be on an accrual basis with respect to sales of goods, purchases, accounts payable and accounts receivable, but the taxpayer may use the cash basis with respect to expenses such as rent, car or truck expense, insurance, etc.
4. **Margin Percent Of Selling Price** -- 
$$\frac{\text{Sales Price} - \text{COGS}}{\text{Sales price}}$$
5. **Mark-Up Percentage Of Cost** -- 
$$\frac{\text{Total Sales} - \text{COGS}}{\text{COGS}}$$
6. **Net Cost** -- Dealer's cost of merchandise for sale.  
Wholesale cost.
7. **Principle Industry Activity (PIA) Code** -- Listing which identifies the taxpayer's business or profession in his or her opinion. The codes are listed on the back of Form Schedule C.
8. **Reconstruction Of Taxable Income** -- In the absence of adequate records, authority is given by the Secretary, to recompute taxable income based on an indirect method. Methods include, bank deposit analysis, cash transaction analysis, source and application of funds, net worth and percentage, or unit mark-up method.



## FOOD CATERING TRUCK TERMINOLOGY

1. **Cold Truck** -- Catering trucks which sell pre-packaged food such as cold sandwiches, for example, self-service industrial catering vehicle.
2. **Commissary** -- Wholesale supermarket where catering truck drivers purchase food in bulk.
3. **Fleet Operator** -- Person(s) who own a number of catering trucks and hire individuals to drive their trucks.
4. **Food Sales** -- An industry which is designed to manufacture or purchase food products for sale to wholesalers or the public.
5. **Hot Trucks** -- Catering trucks which prepare and serve hot food such as full breakfast, hamburgers, burritos, tacos, etc., for example, mobile food preparation unit.

## ESPRESSO TERMINOLOGY

1. **Biscotti** -- A delicate, cigar-shaped cookie often served with espresso or cappuccino drinks.
2. **Coda Di Topo** -- An Italian term meaning "tail of the mouse." The term refers to the ideal trickle of espresso as it flows through the brewing cycle. This may be likened to the flow of honey or syrup dripping from a spoon.
3. **Coffea Arabica** -- One of the most widely used species of coffee and generally regarded as the most flavorful.
4. **Coffea Robusta** -- One of the most widely used species of coffee and generally regarded as inferior to Arabica. Robusta is a lowland plant and is less susceptible to disease than Arabica. It is also less expensive, and is often blended with small amounts of Arabica in typical grocery store brands of canned coffee. (Robusta is also reported to contain twice the caffeine of Arabica.)

5. **Coffeol** -- Often referred to as "coffee oil," coffeol is the substance liberated through the roasting process. Sugars, starches and fats are caramelized during roasting to create the coffeol. ("Oil" is a misnomer in describing the coffee essence, since the coffeol substance is water soluble.)
6. **Crema** -- A light, cinnamon brown froth constituting the crowning layer of the brewed espresso. The aroma of espresso is trapped in the crema, and is often regarded as a measure of the skill of the brewer.
7. **Espresso** -- The delicious, romantic beverage created by brewing only one or two cups at a time, produced as the result of precisely heated water being forced quickly under pressure through carefully ground and packed coffee.
8. **Espresso Grind** -- The term describing coffee beans ground to a fine, gritty, but not powdery texture suitable for brewing espresso or cappuccino. The grind is finer than that of beans ground for brewing in drip or percolator processes.
9. **Espresso Roast** -- The term commonly used to describe blends of complementary coffee beans that have been dark roasted.
10. **Frothing** -- The process of creating hot, foamed milk, using a steam wand attached to an espresso machine. The steam wand is used to inject steam into the milk, thus heating and expanding the mixture. To froth, the wand must be held just high enough in the milk to allow air to be pulled into the milk, creating tiny bubbles that will rise to the top and become foam.
11. **Pull** -- A term applied to the act of grinding the beans in commercial espresso applications. A "pull" generally grinds just enough beans to brew a "shot" of espresso.
12. **Ristretto** -- A shortened "shot" of espresso. While the traditional "shot" is about 1 1/2 ounces, the ristretto is slightly less than an ounce, resulting in a more powerful dose of espresso.

- 13. Roasts** -- The general descriptive terms referring to the degree to which the coffee beans are roasted. Espresso is best made from dark roasts, although there are varying degrees of darkness. Many descriptive terms are added to describe the roast and blend of beans (such as, espresso roast, Italian roast, French roast, Viennese blend, Gold Coast blends, etc.)
- 14. Shot** -- The term commonly referring to the amount of coffee used to prepare an espresso drink. The recommended dosage is generally about 6 or 7 grams of ground coffee (about a quarter ounce): Approximately 1 1/2 ounces of water is passed through the coffee grounds under pressure creating a shot of espresso.
- Single shot: A single dose as described above. Also referred to as "solo."**
- Double shot: A double dose as described above. Also referred to as "doppio."**
- 15. Tamping** -- The process of compacting and packing the coffee grounds in the filter. This causes better extraction of the flavor "oils" because the espresso brewing process forces water through the grounds under pressure, rather than letting the force of gravity carry the water over and through the grounds.

#### **TASTING TERMINOLOGY**

- 1. Acidity** -- The sharp, lively quality characteristic of all high-grown coffees. Acid is not the same as bitter or sour, and has nothing to do with objective ph factors. It is the brisk, snappy quality that makes coffee refreshing.
- 2. Aroma** -- The odor or fragrance of brewed coffee. (Descriptive terms such as caramelly, carbony, chocolaty, fruity, floral, herbal, malty, rich, rounded, or spicy are often used.)
- 3. Bitter** -- A basic taste perceived primarily at the back of the tongue. Bitterness is often caused by overextraction (using too little coffee, too finely ground).

4. **Bland** -- A pale, insipid flavor. Often caused by underextraction.
5. **Body** -- The tactile impression of the weight of the brewed beverage in the mouth. It may range from watery to thin. (Descriptive terms such as light, medium, full, buttery, or syrupy are commonly used to describe body.)
6. **Bouquet** -- A term used in the context similar to aroma, but referring to the smell of the coffee grounds (as opposed to the brewed coffee).
7. **Briny** -- A salty sensation caused by application of excessive heat after brewing. (This is also a characteristic of coffee that has been left sitting for prolonged periods.)
8. **Earthy** -- A term often used to describe the spicy taste of some coffees. In its more extreme usage, the term describes a dirty taste which may actually result from drying beans on the ground.
9. **Exotic** -- An unusual aroma or flavor, such as floral or berry.
10. **Flavor** -- The total impression of aroma, acidity, and body. It can be used in a general sense ("this coffee is flavorful") or with specific attributes in mind ("this coffee has a flavor like chocolate").
11. **Mellow** -- Well balanced coffee of low-to-medium acidity.
12. **Mild** -- Delicate flavor. Also a coffee trade term for any arabica coffee other than those from Brazil.
13. **Soft** -- Another term used to describe low-acid coffees (such as mellow).
14. **Sour** -- A primary taste perceived by the tongue and often characteristic of light-roasted coffees.
15. **Spicy** -- An aroma or flavor reminiscent of a particular spice.
16. **Strong** -- This term may be used in several contexts. In the most technical sense, it refers to the degree of presence of various taste virtues or defects. It is also used to refer to the relative proportion of coffee solubles to water in a given brew. The more popular usage of the term refers to the flavor of dark-roasted beans.

17. **Sweet** -- A general term applied to smooth, palatable coffee, free from defects and harsh flavors.
18. **Tangy** -- A darting sourness, almost fruitlike in nature.
19. **Wild** -- Coffee with extreme flavor characteristics. These may be either positive attributes or defects.
20. **Winy** -- A desirable flavor reminiscent of fine red wine.

### ESPRESSO DRINKS

1. **Americano** -- A shot of espresso to which hot water is added creating a richer and more flavorful cup of coffee than that produced by other brewing methods. Sugar, milk, or other flavorings may be added.
2. **Americano Cubes** -- Basically, Americano frozen into ice cubes. Americano holds up to freezing better than straight espresso. When used in iced coffee drinks, these cubes avoid the dilution of flavors that occurs when plain ice cubes are used.
3. **Breve** -- An additional term referring to the use of half and half instead of milk.
4. **Caffe Latte** -- Technically, espresso with steamed milk and little or no foam. The term has been expanded to include addition of frothed milk. (The addition of frothed milk tends to obscure the difference between a latte and cappuccino.) Cafe au lait is the French term equivalent to caffe latte (Italian).
5. **Caffe Mocha** -- Essentially, a latte added to chocolate syrup and often topped with whipped cream, grated chocolate, or powdered cocoa.
6. **Cappuccino** -- A coffee beverage consisting of espresso and steamed milk and often served with powdered cinnamon and topped with whipped cream.  
  
Recipes often vary: Some include steamed and frothed milk.
7. **Espresso Macchiato** -- A shot of espresso "marked" with a tablespoon of frothed milk.

8. **Espresso Romano** -- A single shot of espresso served with a twist or slice of lemon on the side.
9. **Iced Caffe Latte** -- Same as caffe latte, except that a substantial amount of ice cubes or Americano cubes (see below) are added.
10. **Granita Di Caffe (Or Simply, Granita)** -- A cold coffee drink prepared in a form similar to the "slurpie" or "slushie" soft drink. The recipe commonly includes espresso, sugar, water, and milk (and may also include unsweetened cocoa).
11. **Latte Macchiato** -- A glass or mug of steamed and frothed milk "marked" by a tablespoon of espresso dripped through the foam.
12. **Skinny** -- An additional term referring to the use of non-fat or skim milk.