

Examination Techniques for the Food and Beverages Industries (Restaurants and Bars)

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Introduction

Restaurants can be *full service* food operations, where one is seated and orders from a wait person, paying at the end of the meal, with an average check of \$15 and above. Restaurants can be *limited service* food operations, such as fast food or casual dining, where one orders, pays for, and picks up their own food and may clear their own table, with an average check of less than \$10. Both types may offer take out food or may deliver food.

Both full service and limited service restaurants may be chains, which simply mean there are more restaurants like it in other locations.

Both full service and limited service restaurants may be franchises, which means an owner has purchased a license (called a franchise) to sell a restaurant's food and use its brand, logos, and name.

But one fact that is consistent is that all restaurants have numerous sales transactions with small dollar amounts, taking place in a short time frame, such as during lunch or dinner. Many restaurants, especially smaller or closely held ones, are cash intensive and employees and/or owners handle large volumes of cash transactions every day.

For this reason, it is important to evaluate internal controls. When a sole proprietor counts cash at the end of the day, records all entries in the sales journal and makes the bank deposits, there is a possibility not all cash is reported and deposited. This can also be true when the same person takes the order, fills the order, receives the payment, records the payment and may even balance the cash register at the end of the day.

Restaurants have a high rate of turnover of employees who often have access to the inventories as well as the cash. As such, there is a potential risk of employee theft and embezzlement unless the restaurant implements and maintains a set of good internal controls.

Conversely, there are restaurants that have proper accounting systems, a good system of internal controls, and owners who report all transactions. These tend to be successful and profitable businesses, partly because once a system is designed that truthfully accounts for every transaction, owners have the information supplied to them from the accounting system and make accurate and wise management decisions.

The challenge for the examiner is to separate restaurant owners who are in compliance with the tax laws from restaurant owners who have failed to satisfy their tax obligations. To do this, the examiner should focus on:

- internal controls

- unreported income by the restaurant,
- cost of sales, and
- Unreported tip income by the employees.

Income

Restaurants and Bars usually have a large volume of transactions each day, they allow employees to handle cash sales and cash tips, and they receive significant cash receipts in a small period of time. For these reasons, the examiner will need to *assess internal controls* and adequately *probe for possible unreported income*.

The examiner should have the taxpayer explain how the entire customer process, from the food order to paying the check, gets recorded in the books, by whom and where. Since there will be a large volume of anonymous transactions it will be difficult to trace specific items to receipts. Instead, trace the process and test amounts:

- Examine the customer checks for a sample shift, for example the 6:00 a.m. to 2:00 p.m. shift for a breakfast diner. Total the customer checks and determine where the income is initially recorded. It may be entered into a cash register and recorded on the tape, or it may be stored in a cash drawer and counted at the end of the shift.
- Count the number of checks the servers turned in for the shift. This is the number of customers that each server waited on during their shift. Is the amount consistent with the taxpayer's initial interview statements?
- (Also, make a note of the items sold. Later, when you examine COGS, see if those items are replenished within a day or two. This could lead to the discovery that items not reported as sold, are continually being replenished.
- This may be a source of underreported income or overstated COGS.)
- Total the checks turned in by each server and match their entry to accounting records, such as daily sheets. Trace this amount to the monthly records and verify with the amount reported in the Statement of Profits and Losses.
- Note the ratio of cash, check, debit card and credit card payments by customers. Is this consistent with the taxpayer's initial interview statements? Is it appropriate for the business? Is the customer payment method consistent with the examiner's observations?
- Determine how cash is stored, used and/or deposited? Many times the full amount of cash is not deposited. A set amount of cash may be retained to be used as change or to pay vendors. For your sample day, if the cash received is not the amount deposited, have the taxpayer explain how the cash was used. Even though the gross receipts should be determined from sales, not the bank deposits, it is helpful to account for all of the cash for a sample period to acquaint you with the business operations and to understand the taxpayer's policies on the use of cash.
- Apply the taxpayer's stated mark-up to purchases reported in the books. Is it consistent with reported gross receipts?

Cash management practices are a good indicator of the reliability of internal controls. If the restaurant or bar has no point-of-sales system that requires all transactions to be recorded, ask how they insure proper reporting and what measures are in place to discourage theft.

Internal controls can also be lacking in a system in which the controls designed for the point-of-sales system are not implemented, such as the recording of cash tips. This means that all of the cash received from customers is not accounted for and correct income is not reported. Usually in a bar, one person (for example, the bartender) may be handling all of the cash transactions including balancing out the cash drawers each day. This lack of separation of duties essential to a system of controls necessitates extending the income probe beyond the minimum required by the IRM.

Additional Income Issues

If additional income probes are needed, consider the use of a full bank deposit analysis, the net worth method, a source and application of funds analysis, or the specific item method. Additional probes usually require the use of third-party contacts and third-party contact procedures need to be followed. (See IRM 4.10.4.5.3 (4) and/or 4.10.4.5.2 (4)). It is necessary to get complete information about non-taxable sources of cash, which may explain any understatements. This is especially true of cash on hand and of cash hoards. (See IRM 4.10.3.8.4.)

Since the bar or restaurant industry is largely a cash-based one, the indirect methods discussed in this section may only show that an understatement of income exists. It may be hard or impossible to detect how the understatement was achieved. For example, the taxpayer may only be reporting income from one cash register when two are used, etc. The only way to possibly uncover this is to ask a lot of questions and keep your eyes open during the tour of the business. Another helpful technique is to visit the operation during its normal business hours and observe how transactions are handled. Additionally, you may find it useful to contact state regulatory agencies such as liquor control boards or gambling operations boards. These state boards routinely send agents to restaurants and bars to sit in on the business operations unannounced and observe the operations. They prepare a report of their observations, which may be available to the IRS examiner.

Bar Income

As in any income tax examination, the auditing techniques used depend on the quality and quantity of the taxpayer's books and records. If the taxpayer is a large bar that maintains inventory records which detail the daily and/or monthly purchases and sales of liquor, then the liquor cost percentage can be computed and applied to total purchases to determine the gross receipts and gross profit of the taxpayer. If the taxpayer is a small "Mom and Pop" bar that does not maintain detailed purchase and sale records, it may be difficult and time consuming to compute the purchases for one day or one month. In this case, it may be preferable to rely (at least in part) on third-party information to verify purchases and compute the mark-up on cost. The mark-up may then be applied to total purchases of similar items to approximate the business gross receipts and gross profit.

Using the Liquor Cost Percentage to Compute Gross Receipts

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

1. Determine the cost of some of the more popular brands of liquor
2. Determine the sales values of the bottle if all liquor out of these bottles were sold
3. Divide the sales value into the cost to get the potential pouring cost

Example 1

Computing the liquor cost percentage:

1. Determine the cost of liquor:
The taxpayer's records and verification from third-party sources indicate that the cost per quart is \$4.48.
2. Determine the sales value of the bottle:
A quart has 32 ounces in it. If the taxpayer poured 1-1/4 ounces per drink, there would be 25.60 drinks per bottle. ($32/1.25 = 25.60$)

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

3. Determine the pouring cost percent:

Cost per bottle/Sales value = Pouring cost %

This gives you the potential pouring cost percent.

Cost \$4.48
Sales value \$26.19

= 17.1%

4. Determine the gross sales:

Purchases/Pouring cost % = Gross sales

If 17.1 percent is applied to total purchases of \$5,000, the gross receipts should be \$29,239.77 or (\$5,000/17.1% = \$29,239.77).

Gross Receipts (100%)	\$29,239.77
Less: Purchases (17.1%)	<u>(\$ 5,000.00)</u>
Gross Profit (82.9%)	\$24,239.77

(Note: Using the formula discussed above, the computations could be used to calculate the total sales value of all bottles sold in a week or a month, etc. Consider a factor for waste and spoilage of about 5% to 8%. Also, subtract out the sales tax from the cost.)

Using the Mark-up on Cost Method to compute the Gross Receipts

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

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

Example 2

Simplified
Sales Price 10.00
Cost 5.00
Gross Profit 5.00

Mark-Up on Cost = Sales price/Cost

\$10.00/\$5.00 = 200%

The following steps should be taken to compute gross receipts based on mark-up on cost:

1. Determine the mark-up of the various alcoholic items the taxpayer sells. The mark-up should be determined, if possible, in the initial interview. If the taxpayer does not know the mark-up of the bar items, you must compute it based on the sales price of drinks and the cost of the drinks.
2. Determine the purchases made by the taxpayer.
You can obtain this information from the invoices provided by the taxpayer, if available and accurate. If accurate records are not available, you should request the names of all of the vendors from the taxpayer in the initial interview. Following third-party contact procedures, send letters to the vendors requesting all records of purchases made by the taxpayer in the years under examination or contact other available sources.
3. Apply the mark-up to the purchases of the various types of alcohol.

As in the earlier simplified example:

Cost x Mark-up = Projected sales price

Mark-up = 200%
Cost = \$ 5.00
Sales Price = \$10.00
(\$5.00 X 200% = \$10.00 Projected sales price)

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

**Sales price per drink/Cost per drink/ mark-up of drink
Computing the mark-ups on the various types of drinks.**

Alcoholic Drinks

Sales Price per Drink -- Take the average of the more popular drinks served in the bar, as stated by the taxpayer in the initial interview. It is also important to determine the amount of alcohol in each drink, comparing the taxpayer's statements to a bartender recipe guide.

Cost per drink = Bottle price / Number of drinks in bottle

The bottle price is an average price of alcohol based on information from your local liquor dispensary.

Draft Beer

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

Sales price is based on the price of the beer as listed on the menu and confirmed during the initial interview. Divide the sales price by the size of the drink to get the sales price per ounce. It is important to determine the size of beers served, ounces in each glass, pitcher, etc.

Bottled/ Canned Beer

Sales price of the bottled/canned beer is based on the price for the bottle according to the menu and the taxpayer's statements in the initial interview.

Cost of the beer is an average cost of beers available for sale by the taxpayer. Bottles and cans are usually sold by 12-pack or case (24); therefore, divide the cost by 12 or 24.

Wine

Sales price per glass is based on the price listed in the menu. Divide the sales price by the size of the glass to get sales price per ounce. It is important to determine in initial interview the ounces in each serving.

Cost of the wine is an average cost of wine available for sale by the taxpayer. Wine can be sold by the bottle, box, or keg, therefore, take the cost of the unit divided by the number of ounces to get a cost per ounce.

Wine Coolers

Sales price by the bottle is based on the menu price and confirmed by the taxpayer in the initial interview. Cost of the bottle is an average cost of wine available for sale by the taxpayer. Wine coolers are usually sold in case lots of 24. Divide the cost by 24 to get the cost per the bottle.

Court Case on Percent of Markup Method

The percent of markup method of establishing income is illustrated in *Cebollero v. Commissioner*, T.C. Memo. 1990-618, aff.d, 967 F.2d 986 (4th Cir. 1992). During 1982, 1983 and 1984, Manuel Cebollero owned a retail liquor store in partnership with his former wife. Because the Service was unable to confirm the percentage markups provided by Mr. Cebollero, the prices on Mr. Cebollero's price list and his cost of goods sold figures were used. The Service computed Mr. Cebollero's markup figures by dividing the sales price for each item on the price list by its cost. The Service made no adjustment for sales or discounts.

This computation revealed that Mr. Cebollero's mark-up was exactly what he said it was. It also revealed a large understatement of gross income.

The Court largely agreed with the Service, but allowed an adjustment for items sold at sale prices.

Employee Tip Income Reconstruction Using Indirect Methods

Employee tip income is income under IRC section 61 and Treas. Reg. section 1.61-2(a) (1) and can be reconstructed using indirect methods. The percentage markup method is one of the most often used methods to reconstruct unreported tips, although the cash expenditures method is also used. The McQuatters formula is also a common method to determine the tips as an hourly amount, a percentage of gross sales or receipts, or a percentage of the taxpayer's wages.

The McQuatters formula is illustrated in the case from which it gets its name, *McQuatters, et. al. v. Commissioner*, T.C. Memo. 1973-240. During 1967 and 1968, Lorna McQuatters was employed as a waitress at the Space Needle Restaurant. Ms. McQuatters kept no records of her tip income for these years. Therefore, the Service determined her tip income indirectly by the following method: (1) total sales of food and beverages reduced by 10 percent to allow for low or no tips and tip-sharing; (2) this amount (that is, sales subject to tips) was divided by the total number of hours worked by all waitresses during the year to arrive at sales-per-waitress-per-hour average; (3) this average was multiplied by the number of hours in each year that Ms. McQuatters worked to determine her yearly sales; and (4) her yearly sales were multiplied by 12 percent to compute her yearly tip income.

The Court reduced the tip income percentage from twelve percent to ten percent. Otherwise, because Ms. McQuatters kept no records of her tip income, the Court upheld the Service's determination.

(Note: Extending the income tax examination of the restaurant to include employee examinations should be coordinated with the employment tax group. If you believe an employee examination is warranted, contact your Area employment tax group or make a referral.)

Income from Coin-Operated Activities

Coin-operated machines located in bars or restaurants constitute another important source of income. Coin-operated machines may include jukeboxes, cigarette machines, pool tables, dart boards, video games, candy machines, etc. These machines can be owned by the taxpayer or leased from another party. If the machines are leased, the general rule is that the income generated from the machines is split based on some percentage determined by the owner of the machine.

Income generated from coin-operated activities is very difficult to determine accurately. Therefore, the examiner will review the contracts and question the taxpayer in the initial interview regarding the operation and income generated by these machines. It may be necessary to secure third-party information to compute this income. Additionally, it may be helpful to check Internet resources including the Small Business Administration. Many vending machine companies also have information regarding average annual sales per machines.

Rebates from Supplies

It is common practice in the restaurant industry for suppliers to enter into supplier arrangements with restaurants. Typically, these arrangements extend beyond the taxable year. For example, suppose that Supplier A enters into an agreement with a restaurant chain to supply soft drink concentrate. The contract states that the supplier will advance \$5,000,000 to the restaurant chain immediately and in return the restaurant agrees to purchase all of its soft drinks from Supplier A for the next 5 years. The Service's position is that upfront payments received under supplier agreements are income upon receipt.

Other Potential Sources of Income Activities include:

- Lottery tickets
- Gaming pools
- Vending machines
- Franchise rebate income

- Tenant/fixture allowance
- Supplier or advertising rebates/incentives/reimbursement
- Sales of assets
- Cover charges for admissions
- Selling concessions at sporting events/banquets/high schools
- Renting out rooms for weddings and birthdays, etc.
- Catering
- Banquets
- Bartering
- Related party transactions
- Kickback from vendors
- Renting space for signs and video machines

These possible sources of income should be considered during the initial interview. The examiner will ask pertinent questions to determine if the taxpayer engages in these activities and how any income, including cash, is handled and reported on the tax return.

Cost of Goods Sold

The use of statistical and ratio analyses is a useful pre-audit tool for an examiner. This can tell the examiner if the Cost of Goods Sold is overstated or out of balance in comparison with reported Gross Receipts. This could occur when the inventory amounts are 'estimated', when there is theft or personal use of inventory, or when gross receipts are under-reported.

Statistical and ratio analyses are not tests of the reliability of reported income or expenses and cannot be substituted for an income probe audit step. Rather, the use of statistics and ratio analysis in pre-audit may indicate that additional audit steps are warranted. The examiner still needs to perform audit tests to determine if the taxpayer's books and records can be relied upon and must use direct or indirect methods to determine gross income. If necessary, however, ratios can be used to support audit conclusions arrived at using these methods.

Perform a comparative analysis for the current year, the prior year and the subsequent year.

Calculate Gross Profit Ratio (for at least three years)

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

This ratio shows how much of the sales represent gross profit.

Compare the gross profit percentage (GPP) with the ratios of similar businesses. You can use BizStats.com or Restaurant.org for this information. The GPP should be consistent with industry standards and be sufficient to produce a net profit.

Compare the GPP of the current year to the prior and subsequent years' GPP. The GPP should be consistent in a business from year to year. A low GPP may indicate a problem with inventory valuation.

The examiner should ask the taxpayer for their mark-up percentage during the initial interview and compare that percentage with the calculated GPP. Any discrepancy should be followed up with the taxpayer and the explanation should be recorded in the work papers.

Example of GPP Calculation:

Gross Sales	\$100,000	100%
Cost of Goods Sold	\$70,000	70%
Gross Profit	\$30,000	30%

$$\frac{\$100,000 - \$70,000}{\$100,000} = 30\% \text{ GPP}$$

Inventory Turnover (for at least three years)

$$\frac{\text{Cost of Goods Sold}}{(\text{Beg Inventory} + \text{End Inventory}) / 2} = \text{Inventory Turnover Rate}$$

This ratio computes the number of times the inventory 'turned over' or was sold during the year. It is an indicator of a business's profitability because when inventory turnover decreases, sales and net profit decrease. Conversely, when inventory turnover increases, sales and profits increase. This is because the goal of all retailers is to sell the inventory at a profit and buy more.

Compare the inventory turnover rate with the ratios of similar businesses. You can use BizStats.com or Restaurant.org for this information. The inventory turnover should be consistent with industry standards.

Compare the turnover of the current year to the prior and subsequent years' inventory turnover. This will show if purchases and sales are consistent from year to year. Any deviations should be questioned.

A low inventory turnover rate should be questioned.

Compare the inventory turnover rate to the GPP. The ratios should parallel each other: increased GPP will be coupled with increased inventory turnover rate. If the GPP has decreased from last year, but the inventory turnover has increased, the Cost of Goods Sold may be overstated and/or the inventory amounts are not correct. This should be questioned and recorded in the work papers.

Example of Inventory Turnover Rate:

Beginning Inventory \$156,000
Ending Inventory 178,000
Cost of Goods Sold 700,000

$$\frac{\$700,000}{(\$156,000 + \$178,000) / 2} = 4.19 \text{ times during the year}$$

Percentage of Increase or Decrease in Ending Inventory (for at least three years)

$$\frac{\text{End Inventory} - \text{Beg Inventory}}{\text{Beg Inventory}} = \% \text{ Change in Inventory}$$

This ratio shows any significant variations from year to year. It can indicate an overstatement in Cost of Goods Sold.

Compare the % change in ending inventory balances of the current year to the prior and subsequent years' amounts. Any significant increase or decrease in ending inventory should be questioned.

Example of Change in Ending Inventory Balance:

Beginning Inventory	\$156,000
Ending Inventory	\$178,000
Cost of Goods Sold	\$700,000

$$\frac{\$178,000 - \$156,000}{\$156,000} = 14.10\%$$

Ratio patterns can indicate unreported income and suggest a need for additional income probes. For example, an analysis of a restaurant return indicates that the restaurant has suffered losses for 3 consecutive years or longer and has a high ratio of cost of goods sold to sales. It is reasonable to question the source of the cash necessary for the restaurant to continue operating under these circumstances.

Inspecting the cash flow statement may pinpoint potential sources and assist in preparing a Source and Application of Funds.

If the same restaurant showed an increasing inventory turnover rate (indicative of increased profits), it would be reasonable to question the veracity of the inventory and purchases. Overstated Cost of Goods Sold lowers income.

Once the examiner has the books and records they can analyze the ratio of sales per employee. If this ratio is low relative to the industry, it may be useful to inquire about the turnover ratio of the employees. If, by inspecting the Forms W-2 and payroll records, it appears that the turnover ratio is high, it may be reasonable to assume that the recurring cost of employee training is the cause of the relatively low sales per employee. A restaurant with high employee turnover may not be entitled to take the Work Opportunity Credits or the Welfare to Work Credit. (See IRC sections 51 and 51A.)

Other Ratios

Following are some additional ratios that can be calculated using the facts from the books and records, and compared to industry statistics. The examiner should question the taxpayer regarding any discrepancy and record the taxpayer's response.

1. Prime Cost % = Prime Cost (cost of food and beverage sold plus Labor cost)/Total Sales
2. Food Cost % = Food Cost /Food Sales *
3. Labor Cost % = Total Labor Cost/Total Sales
4. Liquor Cost % = Liquor Cost/Liquor Sales
5. Wine Cost % = Wine Cost/Wine Sales
6. Beer Cost % = Beer Cost/Beer Sales
7. General and Administrative % = General Administrative Cost/Total Sales
8. Sales per Seat = Total Sales/Number of Restaurant Seats
9. Sales per Square Foot = Total Sales/Restaurant Square Footage
10. Sales per Labor Hour = Sales/Full Time Employees
11. Inventory Turnover = Cost of Goods Sold/Average Inventory

*Food cost includes coffee, tea, and juices sold with the meal. If no alcohol is sold, food costs include soft drinks.

Expenses

Package Design Costs

Food and beverage companies incur significant costs in developing package designs for their products. Package design costs are costs incurred to develop the shape, size, graphics, etc. on a product package. The Internal Revenue Service has issued guidance in the form of a coordinated issue paper and several Revenue Procedures (Revenue Procedures 90-63, 97-35, 97-37, 98-39) and Revenue Ruling

89-23 stating that these costs are capital in nature and depending upon the election a taxpayer makes, are recoverable over four or five years.

The issue was litigated (RJR Nabisco, Inc., et al., v. Commissioner. T.C. Memo. 1998-252). the taxpayer convinced the court that package design costs are merely a form of advertising (point of purchase advertising), and as such are currently deductible. The Internal Revenue Service argued that although there are some advertising characteristics present, the fact that there is a long term benefit dictates that these costs are capital in nature and therefore must be capitalized.

The final regulations on capitalization of intangibles were issued in December, 2003. One major impact in the food industry deals with package design costs. It is extremely important to remember that the final regulations are effective for package design costs incurred on or after December 31, 2003. The final regulations are not retroactive. Some taxpayers have filed claims to expense package design costs and these claims should not be allowed! The package design coordinated issue paper is still effective for costs incurred prior to December 31, 2003. The package design cost coordinated issue paper will not be de-coordinated for several more years, since we are currently examining years prior to 2003. Several cases have gone to Appeals and they are supporting us on this issue.

On March 24, 2004, guidance on accounting method changes for capitalization of intangibles was issued in the form of Revenue Procedure 2004-23. This revenue procedure only applies for a taxpayer's first taxable year ending on or after December 31, 2003. It should be noted under the final regulations that the section 481(a) adjustment is determined by taking into account only amounts paid or incurred in taxable years ending on or after January 24, 2002.

The Service has received several Form 3115s from taxpayers seeking to change to expense package design costs prior to the effective date of the final regulations. These requests have been denied by the Service. Taxpayers should be filing amended returns for these prior years (capitalizing package design costs) in order to be eligible to use this revenue procedure. You will want to refer to the revenue procedure for specific examples and special rules.

Revenue Procedure 2005-09 was issued for the taxpayer's second year ending on or after December 31, 2003.

Charitable Contributions of Food Inventory

The rules for charitable contributions of food inventory are slightly different from ordinary contributions of inventory because Congressional intent is to encourage charitable contributions of excess food that would otherwise go to waste.

IRC Section 170(e) (3) allows an enhanced deduction for qualifying contributions of food inventory. This deduction is equal to the basis of the property contributed plus one half of the appreciation, not to exceed twice the basis. This amount would be treated as a contribution and cost of goods sold would be reduced by the basis of the property contributed. More information can be found in [Publication 526 Charitable Contributions section on Food Inventory](#).

Areas to inspect include if a Taxpayer took the enhanced deduction but did not reduce cost of goods sold by the basis of the property, or that the contribution was made to an organization that is not a qualifying organization.

Depreciation Accounting Method Change Issue

The government has been considering how best to address three court losses – Brookshire Bros. Holding Inc., v. Commissioner, T.C. Memo. 2001-150, aff'd., 320 F.3d 507 (5th Cir. 2003), Green Forest Manufacturing Inc. v. Commissioner; T.C. Memo. 2003-75; and O'Shaugnessy v. Commissioner, 332 F. 3d 1125 (8th Cir. 2003), rev'g 2001 U.S. Dist. LEXIS 227838 (D. Minn. 2001). These cases involved taxpayers who used a change in accounting method to maximize their depreciation. Typically, we will see

this on Cost Segregation Studies. Guidance was recently released clarifying the government's position in regards to this controversy.

The IRS has published final, temporary, and proposed regulations on whether a change in depreciation or amortization is a change in method of accounting under section 446(e). Effective January 2, 2004, the regulations clarify that, as a general rule, a change in depreciation method, period of recovery, or convention of a depreciable or amortizable asset is an accounting method change. The regulations also clarify that changes to or from a useful life, in salvage value, from single asset accounting to multiple asset accounting, from multiple asset accounting to a different type of multiple asset accounting, and from non-depreciable to depreciable asset treatment are changes in accounting method. The regulations identify several exceptions concerning timing issues. Examples 9 and 10 of the regulations deal specifically with cost segregation studies.

Smallwares (Dishes, Glasses, Silverware, Pots etc.)
(See Rev. Proc. 2002-12).

The trade or business of operating a restaurant (or tavern) requires the use of many items in the preparation, service, and storage of food and beverages. Pots and pans, dishes, silverware, linens, small kitchen appliances and glassware are common examples of these items, known as "**smallwares**" in the restaurant industry.

Before a restaurant opens for business they must purchase all of these small wares. For a full service restaurant with one location, this may be between \$50,000 and \$70,000. Since these would be acquisition costs, which are included in start-up expenses, the cost is subject to IRC section 195 and must be amortized, not deducted.

During the operation of a restaurant, glasses and plates are broken, silverware is lost or destroyed in disposals, napkins are soiled beyond repair, and these items must be replaced. Prior to 2002, restaurant supplies were depreciated over a 5 year class life.

Beginning in 2002, taxpayers engaged in the trade or business of operating a restaurant or tavern can treat the cost of replacement smallwares as non-incidental materials or supplies under Reg. §1.162-3. Consequently, the costs are deductible in the taxable year in which they are received at the restaurant and are available for use. For purposes of this revenue procedure, "received at the restaurant and available for use" does not include smallwares purchased and stored at a warehouse or facility other than the restaurant where the smallwares will be used.

Change in Method of Accounting - Smallwares

If the restaurant is changing from the previous method of depreciating smallwares to this method of expensing the costs, this is a change in their method of accounting to which §§446 and 481 apply. A taxpayer that wants to change its method of accounting for the cost of smallwares to the smallwares method provided in this Rev. Proc. must follow the automatic change in method of accounting provisions of Rev. Proc. 2002-9, 2002-3 I.R.B (or its successor) with the following modification: the scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply.

If this issue is under examination when the taxpayer makes the change in method of accounting, a copy of the Form 3115, Application for Change in Accounting Method, is filed with the national office, and, the taxpayer must provide a copy of the Form 3115 to the examining agent.

The adjustment for the cost of smallwares must take the entire net amount of any §481(a) adjustment into account in computing taxable income for the year of change.

Audit Protection - Smallwares

If a taxpayer complies with the requirements of this revenue procedure and changes its method of accounting for the cost of smallwares to the smallwares method provided in this revenue procedure, the treatment of those costs will not be raised as an issue in any taxable year before the year of change and, if the treatment of the cost of smallwares has already been raised as an issue in a taxable year before the

year of change, that issue will not be further pursued.

Losses Incurred when a Restaurant is closed

Is a taxpayer entitled to deduct the difference between the adjusted basis of the property and its appraised value when a location is closed but not disposed of? In the restaurant industry approximately 80 percent of all new restaurants go out of business within 2-3 years. Conversely, franchised restaurants and national chain restaurants have an 80-90 percent success rate. Some taxpayers are taking the position that when the building is owned, they are entitled to a loss in the form of bonus depreciation equal to the difference between the adjusted basis and the appraised value of the building, when a decision is made to close an unprofitable location. Members of the National Restaurant Association have been working with the Food Technical Advisor to determine what the correct tax position is, given this fact pattern. The National Restaurant Association has requested that this issue be coordinated because both taxpayers and revenue agents during examination are taking inconsistent positions. FSA 200029054 was issued in 2000. The Food Technical Advisor has taken the position that a loss on the Section 1250 property is not allowed until an actual disposition (sale or abandonment) has occurred. The mere closing of the store is not an actual disposition. ***Once the Office of Chief Counsel has given an opinion, consideration will be given to coordinating this issue.***

Depreciation and Cost Segregation Studies

The allocation of costs of a restaurant between Section 1245 and Section 1250 is an issue that is usually examined.

Restaurant buildings owned by the business can be depreciated under the Modified Accelerated Cost Recovery System (MACRS) for 39 years. Some elements of buildings, however, can be separated and identified as tangible personal property. This practice is called cost segregation, which allows recovery of the personal property elements of a restaurant building over a five-year period using the 200-percent declining balance method. The personal property elements qualify for IRC section 179 expense deductions and bonus depreciation under IRC section 168(k). This separate valuation of real and personal property can also reduce state and local taxes imposed on real property.

The portions of the building that are classified as structural components are considered real property and are included in the depreciable basis. The portions of the building that are classified as personal property are separately depreciated.

Following are the classifications that would apply to restaurants:

Change in Method of Accounting - depreciation

If the property was originally placed in service using MACRS after 1986, without cost segregation (that is, without allocating any costs to personal property), and the taxpayer now wants to make the allocation, they must get permission to change their accounting method pursuant to Rev. Proc. 2002-9, App., §2.01. Under this revenue procedure, a taxpayer is allowed to reclassify building elements as personal property and claim a deduction for the depreciation that should have been claimed on those elements.

Rebates to Franchisees from Suppliers

It is common in the restaurant industry for individual restaurant owners and franchisees to receive rebates from suppliers. These rebates usually come from soft drink distributors, french fry suppliers, and bakery/bread items. In most instances these payments are to individuals versus the corporation. Taxpayers may not be issuing 1099's to the recipient. These payments are includible in income of the recipient.

Web Resources for Restaurants

- [Nation's Restaurant News](#)
- [National Restaurant Association](#)

- [Food Institute, Other Food Industry Resources](#)
 - [Wine Institute](#)
 - [Restaurants for Sale - World Wide](#)
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Glossary

Allocated Tips Tips that the employer assigns to the employee in addition to the tips reported by the employee to the employer when tips reported are less than 8 percent of food and drink sales. The employer reports the allocated tips to the IRS on the Form W-2. The employee completes Form 4137 which is attached the employee's tax return. Employer does not pay FICA tax on allocated tips.

Autogratuity An autogratuity is a service charge that is automatically posted to a guest check. An autogratuity affects all items that are linked to it. Percentage autogratuities are different from regular percentage service charges. A 15-percent autogratuity is updated by a point-of-sales system even when checks are split. A regular autogratuity is applied once at the end of the transaction.

Automated Bar Control Systems Computer based systems to control the bar and alcohol operations. This includes a metered system and a keg beer control system. These systems record the number of drinks dispensed, portion sizes, drink pricing, and collect other data on sales such as brand, serving station, hour, and drink type.

Basic Cash Register Machine Has a paper tape of all recorded transactions, an internal meter that records cumulative data totals, and a cash drawer that secures cash receipts. Allows for recording of various food and beverage items, has a sales tax key, and change due. Tips are not recorded.

Call Drink A drink made with a name brand liquor. The brand is usually requested by the customer.

Cashier Banking A central cashier handles payments. Server takes order from the customer, and the cashier rings up the sale, the server takes payment from the customer and gives to the cashier who rings up the payment and makes change and gives the information back to the server to give to the customer. At the end of the shift, the cashier balances out the sales drawer and gives the server a copy of the server's sales and tip report.

Charged Tip Charged tips are tips added to a credit card slip or a room charge slip. Charge tips are paid to the server by the restaurant, since the restaurant receives the full amount of the credit as a deposit to its bank account.

Check employee Employee who deals directly with the customers such as the waiter or server who takes the order and brings the food to the customer. The same employee also gives the customer the check or sales slip, and receives payment from the customer.

Check digit verification Validates the accuracy of credit card account numbers that are entered during transaction processing.

Complementary (Comp) Sales A meal or drink that is served, but the customer is not required to pay. This may happen as management courtesy meals for errors made or for friend's meals. Generally, a tip is left as in the case of a regular paying customer.

Cover Charge Charge for admission into restaurant and bar, usually because of live entertainment.

Diner Discount Funding Programs (DDF) A funding source provides the restaurant with a cash advance that can be used however the owner chooses. In exchange, the funding source receives food and beverage credits generally equal to twice the cash advance amount. The funding source then

provides credits to members who redeem them by signing special credit card receipts for their bills at full price. The restaurant receives a check from the funding source for the tax and tip amounts. The remainder of the bill is applied to the restaurant's advance balance. Revenues are deferred and may not be ever recorded as current income.

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

Employee Banking Employees who maintain their own 'bank' of cash, usually a purse or pouch. The employee takes orders from customers, takes payment from customer, makes change for customer from the 'bank', and keeps records of all sales. The sales total is balanced out against the cash register at the end of the shift.

Employee Tip Report In a point-of-sales system, employee tip reports are printed out at the end of each day. This same report can be cumulated and printed out for each payroll, quarter, or annually in a point-of-sales system. The following totals are included in each report:

1. Gross Receipts (total sales credited under the employee's name)
2. Credit Card Sales (total charged sales)
3. Credit Card Tips (total tips received from credit card sales by employee)
4. Cash Sales (total cash sales under each employee's name)
5. Service Charge receipts (total service charges payable to the employee)
6. Cash Tips Reported (total cash tips reported by employee)

Employee meal Meal eaten on the premises by the employee. Usually considered a nontaxable fringe benefit as a meal provided for the convenience of the employer. Most point-of-sale systems have a separate key for recording employee meals.

Employer FICA Tax Credit Credit against income tax for amount of employer FICA tax paid on employees tips.

Employment Tax Audit Audit of the Forms 941 and 940 for both the employer's share of FICA and the employee's share of FICA and withholding tax.

Expanded Cash Register Machines Records sales, server information, guest check information, discounted meals, promotional or complementary meals, employee meals, and identifiable menu items.

Fast Food Restaurant Does not employ servers who take orders. Customers will place and pick up their own orders and often bus their own tables.

Food Cost The cost of all food items purchased for resale; does not include the cost of supplies. Usually expressed as a ratio of Food Cost/Total Food Sales.

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

Franchise Fee Cost paid to franchise owner for operating a franchise. Other franchise costs include royalties, advertising, rent, etc. The fee to purchase a franchise is amortized. The annual franchise fees to pay advertising, etc. are usually currently deductible.

Full Service Restaurant Servers are employed to take orders and may include alcohol services.

Guest Check Information System Produced by the integrated point of sale system, a guest check is created showing the written description of the order, server's name, number of customers, table number, and how paid, and tip.

Guest Seat Usually each chair in the restaurant is kept track in a point of sales system. Also, each server is assigned a chair or seat. The information used can show how many sales are recorded by each chair or seat.

Indirectly Tipped Employee An employee who receives tips from directly tipped employees through either tip pooling or tip splitting. In a point-of-sales system, employees record their cash tips in the system using an indirect tips or direct tips key.

Integrated Point of Sales Systems Cashiering functions of the expanded cash register machines plus order entry or automation of the ordering process. It captures the order from the time that it is taken, to transmission to the kitchen area, to the time of payment. Time recording is also possible with a link to an actual time clock. Can be linked to a back office computer to convert data into a management analysis system of the data collected.

Keg Beer Control System A push button panel that dispenses the exact portion of beer replaces the conventional beer tap. This is a system usually employed to control portions and prevent theft.

Liquor License Fee Cost of maintaining right to serve alcohol, usually to a government agency. After RRA '93, this intangible asset can be amortized over 15 years for licenses acquired after August 10, 1993. Per GAAP, APB Opinion No. 17 requires disclosure of write-off and use of straight-line method.

Liquor Cost The amount paid for liquor after discounts; does not include bar supplies, mixers, etc. Usually expressed as a ratio: Liquor Cost/Liquor Sales.

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

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

Menu Pricing A technique of calculating the actual cost of goods sold by cost to purchase each ingredient within each item of the menu. For example, determining the cost of a hamburger bun, slice of cheese, and meat. Based on the cost, a profitable selling price for each menu item can be determined.

Metered Systems A system using a metering device to record each drink served. They attempt to hold the bartender accountable for every drink poured. Some systems use a "gun" dispenser that travels through a system of hoses from the storeroom where the liquor is kept to the gun. Other systems use a spout attached to each bottle that dispenses a predetermined portion. The bartender must attach a collar around the spout to activate. The collar records the drink and releases the alcohol.

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

Point of Sales System Usually computerized type of sales register that records the sale at the time the sale occurs. This can include basic electronic cash registers, expanded cash registers, and integrated point of sales systems.

Portion Cost The unit cost times the portion served.

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

Restaurant capacity The amount of customers that can be served if all of the tables and chairs available for use, are used.

Restaurant Development Costs Start-up costs to find a restaurant location, train employees, pre-opening advertising costs, fees paid for demographic studies. Under IRC section 195, these costs are required to be amortized over 60 months.

Service Charge A service charge is any gratuity posted to a check, such as a room service or delivery charge. Direct and indirect tips are not service charges. A point-of-sales system will record a service charge.

Shrinkage The amount lost as a result of cooking or waste.

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

Stiff A stiff is when a customer leaves no tip.

Targeted Jobs Credit Credit against tax for employing targeted groups.

Tip Audit Audit of the employer's share of FICA tax on all the tip income of the employees and not just the tips reported to the employer. Special procedures require involvement with the Tip Coordinator for assessment.

Tips Paid Tips paid out by the restaurant to the server for the credit card tips at the end of the shift when the server cashes out. These tips reduce the cash in the drawer from cash sales and reduce amount deposited to the bank in cash. These tips are recovered when the restaurant receives payment from the credit card companies.

Tips Declared Amount of cash tips reported by the employee to the employer. This is not necessarily the amount of cash tips received.

Tip Percentage The tip percentages is calculated as follows:
Employee's total tips/employee gross sales receipts = tip percentage.

Trade-out Trade-out arrangements are barter activities where the restaurant agrees to provide meals in exchange for some activity.

TRDA Agreements The Service will work with the employer to arrive at a tip rate for the various occupations in the restaurant using the McQuarter's Formula. At least 75 percent of tipped employees must sign a participating agreement. Participating employees report tips at or above the rate determined in the agreement.

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

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

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

TRAC Agreement The employer and the Internal Revenue Service agree to institute and maintain a quarterly educational program that trains newly hired employees and periodically update existing employees as to their reporting obligations with respect to tips. The employer also agrees to establish a procedure to monitor the employees, the accurate reporting of all tips, and comply with all federal tax requirements regarding the filing of returns, paying and depositing taxes, and maintaining records.

Unit Cost The purchase price divided by the applicable unit.

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

Weekly Profit and Loss Reports Internal reports reconciling cash register tapes, deposits, purchases, and cash payouts. Reports provide detailed analysis of sales and costs. These are usually available on all electronic cash registers.

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

Work Opportunity Tax Credit Credit employers can receive for hiring people off of welfare