Cash Intensive Businesses Audit Techniques Guide - Chapter 10 - Beauty and Barber Shops

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Beauty Salon Defined

A cosmetologist is a person who is licensed to perform the mechanical or chemical treatment of the head, face, and scalp for aesthetic rather than medical purposes. These services include hair shampooing, hair cutting, hair arranging, hair braiding, hair coloring, permanent waving, hair relaxing, or non-invasive hair removal, for compensation in a licensed cosmetology salon.

In the Barbering Industry, a licensed barber is only allowed to perform practices to the head, face, and neck of a customer (historically a haircut and shave).

This beauty salon guide is composed of collective information from audits, interviews of salon owners, and contacts with the State departments. This guide is intended to provide an overview of the industry.

Hair, nail and skin care services saw a growth spurt in 2001, with revenues increasing by 78 percent from 2000. In 2001, the industry reached $25.3 billion in revenues. Of this number, sales receipts from barbershops totaled $2.1 billion; beauty salons at $20.8 billion; and nail salons at $2.5 billion. There is a growing popularity of day spas that include these services and that may account for the increase in sales on the hair and salon industry. There is little capital needed to open a salon since it is primarily a service industry.

A typical full service salon may offer

- **Hair:** haircuts, trims, shampoo and conditioning; curling, and styling; hair coloring including all over color, regrowth color and highlights/foils & weaving; hair and scalp treatments; relaxers, perms (permanent waving);
- **Nails:** manicures, pedicures, polish, sculptured or acrylic nails, nail repair, hand conditioning treatments.
- **Skin Care:** Facials, body waxing, massage.

Sale of professional hair/beauty products: Most salon businesses offer a wide range of hair and beauty products in order to provide everything a customer needs in one convenient location. Retailing professional hair products is an important strategy for retaining clients and making additional profits.

The stylists in a salon will either be employees of the salon or will rent only their space (called a booth) from the owner. When stylists rent the booth they pay a monthly rate and order and purchase their own products. They set their own hours and maintain their own books. The salon has no responsibility beyond providing the booth. For example, a stylist earning $1,500 in a week pays the salon $250 for booth rental, then spends about $50 in supplies, and is responsible for paying his or her own estimated tax payments.

When the stylists are employees they work according to the salon’s schedule and use products supplied by the salon. They are not responsible for any bookkeeping beyond reporting their tips. A salon can have both employees and independent stylists. A typical stylist earning $1,500 in a week, as a 50% commissioned employee, will pay the salon $750, use the salons supplies and receive a W-2 at the end of the year.

Whether a stylist is independent or an employee, efficiency is the key factor. A stylist who can take more clients in a day earns more income and tips.

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

Each examination will be unique and challenging. The examination should not be entirely comprised of reconciling the books to return, evaluating internal controls, and testing the reported income, since there is a high possibility that some of the income is unreported.

Additional considerations are:

- Reconciling the reported tax return income to the taxpayer's financial status.
- Evaluating the intensive cash situation to determine the extent of the income probe.
- Designing a test to determine income from known reliable information.

Included in this guide are some examples of ways to use existing information to determine income.

Tour of Business:
When touring the business's premises, observe the different types of business being offered; work stations and how many of each type, the price schedule posted, the appointment procedures, and the payment procedures.

Income

The income section of this guide focuses on unique examination techniques. Traditional auditing techniques are not discussed. For Cash-T or personal living expense evaluation, refer to IRM 4.10.4

Salon Income

Total salon income can be comprised of several sources or just one, depending on what services are offered. Sources of revenue can include, but are not limited to, service income from hairstyling and other services, retail income from product sales, and rental income from booth rentals.

Ideally the financial statements or other recordkeeping will show the amounts of income from each source. If there are no records, the examiner can calculate the amounts based on what is known. For example, income from booth rentals can be easily identified and verified (checks from renter stylists, number of booths times' rental rate, oral testimony, etc.). And income from retail sales can be calculated (state sales tax, markup on supplies purchased, etc.). Once those are calculated, the difference will be service income.

The examiner can use some of the methods described below to identify and segregate the different types of income. This will facilitate focus on potential understatements for each type of revenue.

Service Income

Typical services would include any number of the following:

- Hair Cuts;
- Perms;
- Hair Relaxing;
- Shampoo/Style;
- Hair Coloring;
- Nail Services.
- Skincare/facials;
- Hair Removal;
- Hair Replacement;
- Hair Weaving;
- Hair Braiding;
- Hair Attachment;
- Make-up;
- Tanning;
- Massage.

Service income includes the salon owner's and any employees' income. Because the employees' revenue will be evident from the tax return wage or commission expense, the owner's receipts from services are total service receipts minus employees' receipts.

The salaries/wages of the employees are normally based on productivity. Ask the salon owner to explain how compensation is paid. Some type of productivity record is generally used to determine compensation - request that record or an explanation in writing. Compensation can be based on a commission, a straight salary, or a salary/commission combination. This composition can be used to analyze income.

Method 1 - Service Income Formula

Information needed:

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

Formula:
Wage Expense divided by Commission percentage equals Employee Service Income.

Then:
Total Service Income (from tax return)
Less Employee Service Income
Equals reported Service Income of owner

Analysis of Service Income Reported:
Compare to initial interview, appointment book, and individual income records.

Example - Service Income Formula

Information provided:

1. Employee Commission Percent equals 60%
2. Owner's activity in salon equals 5 days full time
3. Wage expense form the tax return equals $60,000
4. Service revenue from tax return equals $135,000

Formula:
Employee Service Income is $60,000 divided by 60% equals $100,000

Total Service Income from the tax return $135,000
Minus Employee Service Income ($ 100,000)
Equals Reported Service Income of Owner $ 35,000

Analysis of Reported Service Income:
Appointment book averages 8 appointments per day. Assuming 2 weeks of vacation, then 50 weeks were worked.

50 weeks per year times 5 days worked per week equals 250 days worked per year

250 days worked per year times 8 appointments per day equals 2000 appointments per year.

$35,000 divided by 2000 appointments equals $17.50 average price per appointment

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

If the salon has the following standard prices: cut $25, perm $55, and color $30, but the average price per appointment was calculated at $17.50, this would indicate a potential for unreported income. In that case the actual prices for the individual services are above the computed average price per appointment.

Retail Income

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

Method 2 - Retail Income Formula

Information needed:

1. Cost of Goods Sold (COGS) per tax return
2. Retail Income per tax return

Formula:
COGS times 2 equals the Potential Retail Income (Assuming 100% markup)

A second method for reconstructing retail revenue is based on commissions. A common practice in the salon industry is to pay a stylist a 10-15 percent commission when they sell the salon products to their customers. The examiner should ask for this percentage during the interview. If the taxpayer states the amount is less than 10-15 percent, a test should be done to prove this.

When using the commission expense from the tax return be ALERT -- the commission expense might include wages and thus you have an employee vs. independent contractor issue (see section on Employee vs. Independent contractor, below). Separate the wage expense from the actual commission expense. The commission expense can then be used in an algebraic formula to determine retail sales.

Method 3 - Retail Income Formula

Information needed:

1. Commission expense on tax return
2. Commission percent paid on retail sales

Formula:
Commission Expense divided by the Employee Commission percent paid on sales equals Retail Income

There are two items to consider when reconstructing retail sales using this formula:

1. Consideration for special sales on products (there might not be a 100 percent mark-up) and
2. Consideration for "walk- through" traffic where no specific worker receives a commission.

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

Example - Retail Income Formula

Information provided:

1. Commission Expense per Tax Return equals $15,000
2. Commission Percent equals 15%
3. COGS equals $53,000
4. Retail income per tax return equals $105,000

Formula:
COGS times 2 equals the Potential Retail Income
$53,000 times 2 equals $ 106,000

Retail Income equals the Commission Expense divided by Employee Commission Percent paid or $15,000 divided by 15 percent which equals Retail Revenue of $100,000.

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

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

Rental Income

If all stylists are employees there will be no rental income.

If the salon has all booth rentals, the salon owner is a landlord. Verify the available space- how many chairs, or “booths” are there, and the number that were occupied. As with any landlord, be suspicious whenever there are unrented booths. This means the business is operating below capacity and costing the landlord money. It is very unlikely the business would have unrented booths.

Appointment Book

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

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

Example

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

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

In addition to the appointment book, a salon or barbershop may also maintain a daily income summary. This should be tested and compared to the appointment book. In some situations, using only the appointment book, the income reported was very close to the correct income. However, in other situations, income was understated. In one case, it was found that the daily income was understated by about $300 due to numerous walk-in appointments not recorded in the appointment book. In that situation, the barber had, however, recorded the correct income in the daily income summary. The point is that while the appointment book is an important document to review, it may not reflect all services actually rendered. Therefore, it is important to analyze it in conjunction with other available records.

Method 4 - Rental Income Formula

Information needed:

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

Formula:
Flat Rent Paid times Number of Stations times 52 Weeks equal the Rental Revenue (adjust for vacancy rate)

Analysis of Rent Revenue Reported
Total Rent Revenue Reported divided by 52 Weeks equal's weekly rental revenues

Weekly rental revenues divided by the number of stations equal the amount reported per station.

Example - Rental Income Formula

Information Needed:

1. Flat Rate of Rent per Station equals $130
2. Number of Stations equals 10
3. Rent Revenue per Tax Return equals $65,000

Formula:
Flat Rent Paid times Number of Stations times 52 Weeks equal the Rental Revenue (adjust for vacancy rate):

$130 times 10 times 52 equals $67,600

Total Rent Revenue Reported divided by 52 Weeks equal's weekly rental revenues:

$65,000 divided by 52 equals $1,250 per week rental revenue

Weekly rental revenues divided by the number of stations equal the amount reported per station:
$1,250 divided by 10 equals $125 reported per station

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

Indirect Methods
The Service does not have unlimited discretion to use an indirect method. An indirect method should be used only when the facts of the individual case warrant its use. For example, when:

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

   This issue should be documented in the workpapers. If a taxpayer's books and records are inadequate, the examiner should prepare a detailed inventory of the books provided and why they are inadequate. Failure to produce the appointment book for review will usually constitute incomplete records.

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

Identification of likely sources of unreported income is generally necessary for the Service to sustain an indirect method of deficiency. In the case of salons and barbershops, like most cash intensive businesses, the most likely source of unreported cash or other unreported service, retail or rental revenue is the business itself. Courts have upheld the Service in situations in which the taxpayers have likely sources of income and no books and records. Careful documentation of the investigation is essential in sustaining a deficiency in such a case.

Employee VS. Independent Contractor

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

Common Law Factors
The question of whether an individual is an independent contractor or an employee is determined based upon consideration of the facts and application of the law and regulations in each particular case.

See **Professional & Executive Leasing V. Commissioner**, 89, T.C. 225, 232 (1987), aff'd 862 F.2d 751 (9th Cir. 1988); **Simpson v. Commissioner**, 64 T.C. 974m 984 (1975). Guides for determining the existence of that status are found in three substantially similar sections of the Employment Tax Regulations; namely, section 31.3121(d)-1, 31.3306(i)-1, and 31.304(c)-1, relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding, respectively.

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

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

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

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

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

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

As early as possible during the examination, it is important to discuss with the taxpayer the reasons the workers are treated as independent contractors. During the discussion, the examiner should keep notes of the taxpayer's responses. A taxpayer cannot have relied upon recently decided cases as the basis for treating workers as independent contractors for years prior to those decisions. An opinion letter from an attorney written after the examination began is less persuasive than one that was written when the employer first began using workers and treated them as independent contractors. The taxpayer has the burden of establishing industry practice based upon objective criteria substantiated by the taxpayer.

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

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

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

Revenue Rulings and Court Cases

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

> **Revenue Ruling 57-110, 1957-1 C.B. 329**
> Facts: Fixed weekly fee; owner furnished heat, light, water and supplies; barber provides own tools; barber sets own hours of work; and barber collects his own money and does not account to the salon owner for revenue earned.
> Determination: Independent contractor
>
> **Revenue Ruling 70-488, 1970-2 C.B. 219**
> Facts: Barber is paid a percentage of the money from services performed; salon sets hours of work; required to wear a uniform. Determination: Employee
>
> **Revenue Ruling 73-591, 1973-2 C.B. 337**
> Facts: Salon agrees to furnish, repair, and maintain all equipment; hair stylist is paid on a percentage of gross receipts; no credit work or free work can be done without the approval of the salon owner; working hours are set; hair stylist furnished a report each day to the owner reflecting the day's receipts.
> Determination: Employee
>
> **Revenue Ruling 73-592, 1973-2 C.B. 338**
> Facts: Rents for a fixed monthly fee; the salon furnished heat, light, water, and supplies, hair stylist retains the money collected; hair stylist sets own hours of work. Determination: Independent Contractor

Wolfe v. United States, 77-1 U.S.T.C ¶ 9346 (D.N.D. 1977)
Facts: Hair stylists are paid on a percentage of gross receipts; hair stylists handle own clients; hair stylists provide own supplies; appointments are made through one receptionist; hair stylists set their own hours and have their own keys to the shop; money from services is paid to the salon; hair stylist decides what prices to charge; hair stylists are responsible for bounced checks; and hair stylist are not required to work on salon's customers. Decision: Employee

A Henry, d.b.a Center Beauty Shop, 78-1 U.S.T.C. ¶ 9433 (E.D. Tenn 1978)
Facts: Rent is based on a percentage of gross receipts; no receptionist; anyone in the salon will answer the phone; salon furnishes the supplies; hair stylists collect own money; hair stylists set own hours of work; prices were set by an agreement among the hair stylist; and minimum rent payment is $50. Determination: Independent Contractor

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

Tips

Workers in the salon industry supplement their base compensation with tip income. Independent Contractors (booth renters) will report their service and sales revenue plus their tips, as gross receipts. Employees should be reporting tip to their employers. Sample audits completed in Las Vegas, NV, showed tips as high as 22 percent of gross sales, but average tips are usually 10-15% of the bill.

Salon owners may state that they do not receive tips and thus have a 0 percent tip rate, but this is unlikely. A generation ago it was thought that employees should be tipped because their base wages are low, but salon owners should not be tipped because they receive a percentage of each employee's earnings. In today's market all stylists and service providers are tipped. A customer rarely understands whether their stylist is an employee or booth renter, and tips based on the service provided.

As with the restaurant industry, tips are sometimes overlooked as income. The challenge with this issue is determining a reasonably correct rate. This section discusses determining a tip rate and calculating tips.

Useful information may be found in:

- Publication 531, Reporting Tip Income;

- Publication 1244, Employee's Daily Record of Tips and Report to Employer.

Calculating Unreported Tips

On the initial information document request, tip records should be requested (tip diaries, etc.). If no records are maintained or provided to the examiner, tip rates can still be determined without diaries, by using some of the following information:

- Charge slips
- Interviews
- Industry practice
- Observations.

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

The information can be recorded as in the following example:

Service	**Price**	**Tip**	**Tip%**
Hair Cut	$30	$5	16.67%
Perm	$80	$5	6.25%
Frost	$40	$4	10.00%
Total	$150	$14	32.92.%

Total Tip percentage divided by Total number of Sample equals Average Tip percentage.

- Total Service Income $
- Times Average Tip %
- Equals the Tip Income $

Total Tip percentage is 32.92%. Divided by the total sample equal 10.97 average tip percentage. The average tip percentage can then be applied to total gross receipts to arrive at total service income,

Total Service Income

- From Tax Return is $ 47,000.00
- Times Average Tip % 10.97%
- Tip Income equal $ 5,156.00

Corrected gross receipts equal ($47,000 + $5,156) or $52,156.

It may be helpful to review the following court cases that address the tip issue:

- **Bartell v. Commissioner, 48 TCM 461 (1984), T.C. Memo. 1984-34 6**
  Hair stylist in Lord and Taylor Store, Fifth Avenue, New York City, reported the same amount of tips every month in 1978. Commissioner estimated tips at 15 percent of gross sales based on a 1978 nationwide survey of tip income received by service industry employees. Tax Court accepted Commissioner's estimate with slight modification.
- **Becerra v. Commissioner, 28 TCM 108 (1969), T.C. Memo. 196 9-22**
  Case involved a beautician in San Francisco department store in 1965. Commissioner reconstructed tips based on estimate of 8 percent of gross sales, supported by testimony salon manager and co-worker. Tax Court found this estimate reasonable under the evidence presented at trial.
- **Brancaleone v. Commissioner, 22 TCM 1676 (1963), T.C. Memo. 1963-318**
  Beautician in Macy's Department Store kept no record of tips for 1959. Tips received by fellow beauty operator indicate generally whether tips were small or large. Commissioner's method of reconstruction not discussed.
- **Keller v. Commissioner, 48 TCM 332 (1984), T.C. Memo. 1984 -3 14**
  Commissioner estimated tip income at 7.5 percent of gross sales based on average of co-workers' reported tips. Taxpayer had no tip record and Commissioner's reconstruction was upheld.
- **Payne v. Commissioner, 23 TCM 670 (1964), T.C. Memo. 1964-119**
  Taxpayer, a co-worker of Brancaleone, reported 2 percent of gross sales earned by him as tips for 1960 (pursuant to his daily record). Commissioner asserted that tips were 20 percent rate. Although doubtful of reported tips, the Tax Court found for the taxpayer.

IRC section 61 defines tips as reportable and taxable income. IRC section 6053(a) imposes reporting requirements for tip income. An employee is required to give his or her employer a written report of tips earned for each month by the 10th day of the next month. This report is required for each month that an employee receives tips of $20 or more while working for that employer.

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

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

Other Audit Considerations

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

1. **The State Boards of Cosmetology**
   Certain State Boards of Cosmetology (Board) are extremely cooperative and are capable of providing information. Each licensee will have a file at the Board that has a current address and social security number. Also, the Board inspects and prepares an inspection report for each salon. Review the inspection report for useful audit information.
2. **Retail Sales -- Inventory Issue**
   The trend in the salon industry is to start or increase retail sales. This potentially will generate an increase in inventory issues.
3. **Booth Rentals -- Potential Non-filers**
   With the increase in booth rentals, there is a strong possibility that the non-filing of Federal tax returns will increase. The State Board of Cosmetology should have information on which salons have rentals. The Board should also have a list of licenses in the shop at the last inspection. With this list, an examiner can check IDRS and identify any nonfilers.
4. **Computer Software for Salons**
   A Florida examiner audited a salon that had computer software that was specifically designed for a salon. The software accumulated, on a daily basis, a complete record of each sale. The record of each sale included the employee's name, the customer's name, the services rendered, retail sale detail and whether the sale was cash, check, or credit.

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

Initial Interview and Information Document Request

This section will focus on the questions and records designed for the salon industry.

Secure answers to the following questions:

Rental Revenue (Booth Rentals)

1. How many stations are in the salon?

2. How many locations are there for the salon?
3. How many different types of stations in the salon?
4. How many of each type of station are in the salon?
5. Are the stations leased?
6. If the stations are leased - what was the occupancy rate of the stations for the year under audit?
7. Does the shop rent stations to other service providers?
8. What type of stations were rented out, and how many of each type were rented out for the year(s) under examination?
9. Does the salon's owner require a fixed fee for the booth rental? Weekly? Monthly? Bimonthly?
10. Is the fee for the booth rental the same for all cosmetologists?
11. What was the rent for each of the stations rented out?
12. Are there written rental/lease agreements?
13. Other than the space, does the shop provide anything else to the renter (e.g., supplies, towels, phone service, use of receptionist, etc.)? If so, does the shop owner charge a fee for the supplies and services, and how much?
14. Are there written service contracts between the shop owner and the renters?
15. Who pays the State's revenue tax on the station?
16. Who is responsible for the general liability, malpractice or worker's compensation insurance's on the station in the event of an unexpected happening causing loss or injury to the station's clientele?

Service Revenue

1. How many employees are in the salon?
2. What are the appointments procedures?
3. How are the employees compensated?
4. How is compensation determined?
5. Do you have a tanning bed? How many?
6. Do you have a facial table? How many?
7. What are the sources of shop revenue?
8. What are your busy months? Slow months?
9. What type of services does the salon offer and what are the standard prices?
10. How many clients make appointments?
11. Operational questions:
    a. How are walk-ins, cancellations, and no shows designated in the appointment book?
    b. What is the customer tracking system?
    c. Do you maintain customer cards?
    d. Is there a daily/weekly report for each individual?
12. What is the procedure for handling inventory?
13. What services does the shop offer and what are the standard prices?
14. Are there different prices for different stylists/specialists?
15. If different prices are charged for different stylists/specialists, why?

16. Does the salon accept coupons? If so, how are they distributed and how much are the coupons worth? Approximately what percentage of the customers would use the coupons? How often are they distributed?
17. Do you offer discounts (e.g., senior citizens)?
18. How many stations are in the shop? What type are they (e.g., hair stylist, nail technician, massage, etc.)? How many of each type?
19. Are there manicure/pedicure tables in the salon? How many?
20. Does the shop accept customers on an appointment basis only?
21. What percentage are walk-in and what percentage is from appointments?
22. What are the appointment procedures? How do customers make appointments?
23. How are walk-ins, cancellations, and no shows designated in the appointment book?
24. What other recordkeeping system does the shop use other than the appointment book?
25. How services are provided coded in books and records?
26. Does the business offer gift certificates for sale? If so, how are the certificates accounted for? How are the sales of the certificates rung up on the cash register? How are the redemptions of the certificates recorded?
27. How many days a week is the shop open? What are the busy hours?
28. Does the owner close the shop for vacation? If so, how many days closed?
29. What are the shop's busy months? Slow months?
30. How many employees does the shop have? How many in each category (e.g., number of stylists, number of nail technicians. etc.)?
31. What are their responsibilities? Do employees in a category perform all the same functions, or do they specialize in specific tasks? (e.g., male haircuts, perms, hair coloring, etc.)
32. How many days do they work at the shop and how many hours per day?
33. How are they compensated? How is compensation determined?
34. What are the criteria for top performing barbers/cosmetologists within the salon (e.g., talent vs. experience)?
35. How are the tips accounted for? Are there any tip-splitting arrangements?
36. Does the shop owner provide services at the shop? If so, what types of services does he/she provide?
37. How many days does the owner work at the shop? How many hours each day?
38. How are the owner's services booked? Is there a separate appointment book for the owner? Does he/she accept appointments only or walk-ins as well?
39. What is the owner's policy for accepting tips?
40. Does the business provide off-site services? If so, what services are provided and what are the fees for the services rendered off-premises?
41. Who provides the services off-site (e.g., the owner, specific employee(s))?
42. How are off-site appointments recorded?
43. If applicable, what is the state's licensing requirements?
44. Are all the barbers/cosmetologists at the salon state licensed?
45. Does the salon have any specialty licenses (e.g., pedicure, manicure, facials, hair restoration, massage therapy, etc.)?
46. Is the salon located in a tourist area?
47. Does the shop owner own other barbering/cosmetology establishments? If so, how many others? Where are they located?

Salon Owner

1. What type of hairstylist is the salon owner?
2. How many days a week does the owner work?
3. What specific days?
4. What types of services are provided?
5. How often are the appointments booked?
6. What are the requirements for license renewal?
7. What CPE courses and other training did the owner take in the year(s) under examination?
8. What tradeshows, seminars and/or conferences did the owner attend during the years under examination? Where were they held?
9. Did other workers at the shop attend the tradeshows, seminars/conferences?
    a. If so, did the owner pay for their expenses?
    b. If so, which worker(s)?

Retail Revenue

1. Are there retail sales?
2. What products are sold at the shop?
    a. What is the percentage mark-up on products?
    b. What is the gross profit percentage?
3. What percentage is sold to "walk-through" traffic?
4. Are commissions paid to the individuals selling products?
5. What is the percentage paid as commissions on retail sales?
6. Who supplies the retail products?
7. Does the salon have its own line of products?
    a. What are the names of the product lines carried at the shop?
8. Does the shop run sales on the products?
    a. If so, what kind of savings is offered?
    b. How often are sales run?
9. Does the shop accept manufacturer's coupons?
10. Does the shop issue coupons for redemption on products sold at the salon?
    a. If so, in what amount and how often are they issued?
11. Are commissions paid to the individuals selling the products? If so, how much?
12. How are commissions paid to the sellers?
    a. Are the commissions reflected on Form W-2 or Form 1099?

Employee vs. Independent Contractor

1. How many receptionists are employed?
2. How is the weekly/monthly rental rate determined?
3. How much is the weekly/monthly rental rate?
4. Does the individual rent a particular space?
5. Who is responsible for damage to the chair?
6. Is there a maintenance charge for the lease?

7. Are there price requirements for the lease?
8. Who maintains the individual's appointment book?
9. Who collects the money earned by the individuals?
10. Who pays for the individual's supplies?
11. Who maintains the books and records of the individual?
12. Who pays for the phone system in the salon?
13. How many phone lines are in the salon?
14. Are there any manicurists?
    a. Compensation method?
15. Are there assistants who only wash hair?
16. How are the assistants compensated?

Information Document Request - Request the following records:

1. Appointments Book(s)
2. Schedules or worksheets for individuals
3. Cash box receipts
4. Copies of each service slips
5. Lease agreement for stations (booths)
6. Franchise Fee agreements
7. Completed Form 4822 (Personal living expense)
8. Customer cards/files;
9. Salon's price schedule/chart;
10. General liability and malpractice insurance policies;
11. Daily income summaries;
12. Tip diaries and/or Forms 4070A, 4070;
13. Service contracts on booth rentals (for example, receptionist's services, use of phone lines, etc.).

Glossary

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

Booth Renter - An individual that leases a specific area in a salon.

Clientele - A body of customers or patrons.

Cosmetics - Serving to beautify the body.

Cosmetology - The study or art of cosmetics.

Customer Cards - A record maintained on services rendered to a client.

Rental Revenue - Source of income from leasing a specific area in a salon.

Retail Revenue - Source of income from products or supplies sold.

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

Service Revenue - Source of income from providing a service to a client.

State Board of Cosmetology - A state regulatory agency.

Station, Workstation, Booth - A work area used by an individual in a salon.

Strict Chair Lease, Chair Lease - An arrangement with a salon owner and an individual that grants use or occupancy of a location for a certain length of time.

Stylist - A consultant on beauty.

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