

Cash Intensive Businesses Audit Techniques Guide - Chapter 11 - Car Wash

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Car Wash Defined

A car wash is a facility for cleaning the exterior and sometimes the interior of cars. There are many different types of car wash service facilities, including:

Self-serve bays: Single stall drive-in bay with wands and hoses for hands-on customer use. Options are operated on the wand, and include presoak, wash, double soap, pre-rinse, wheel brite and double rinse. The facilities usually have coin operated vacuums for customer self-use. Self serve bays are coin operated.

Self-serve automatic bay: Single stall with a boom or roll over type mechanism applying water, soap and/or wax at high pressure with cloth or brushes touching the vehicle. Customer usually remains in auto. Self serve automatic bays may be coin or token operated, or may be run by an attendant.

Self-serve touchless automatic bay: Single stall without any brushes or cloth, only high pressure water. Options include presoak, wash, double soap, pre-rinse and rinse. Customer usually remains in auto. Self serve automatic bays may be coin or token operated, or may be run by an attendant.

Full service tunnel: Conveyor belt moves the empty car along a tunnel. The tunnel usually has brushes and/or cloth along with high pressure water application and a dryer at the end. Various options include presoak, wheel brite, waxes, undercarriage wash, etc. Employees may also clean the inside of the car and wipe it down upon exit.

Vending: A variety of towels, fresheners, soaps, etc. are sold on the premises through self-service vending machines. Snacks and drinks are also sold in vending machines, and the facility may have arcade games or other coin operated amusements.

Other Businesses and Services

Approximately 65% of car washes dispense gasoline. Many of those locations show their NAICS code as a gasoline and/or service station, and their car wash facility serves as a secondary source of business income.

Other car washes provide complete detailing services which are usually done in a shop adjacent to the car wash. Services include cleaning, washing, waxing, shampooing and vacuuming of both the interior and exterior. This is performed by one or two individuals, and primarily done by hand.

Detail shops can also be found as separate stand alone shops and may be separately owned and operated.

Car wash facilities are often adjacent to shops that sell and install mufflers, perform oil changes and provide other miscellaneous auto-mechanical services.

Background

The pre-audit portion of any examination can provide a wealth of information prior to the initial contact or interview with the taxpayer. The more knowledge of the taxpayer and/or the owners the examiner has before the examination begins, the easier it is to determine important aspects of the taxpayer, such as the assets owned certain items of income, bank accounts, etc. The examiner may also be able to determine the credibility level of the taxpayers based upon their answers to initial interview questions.

Information should be gathered on both the corporate or partnership entity and the shareholder(s)/partner(s) when possible. With respect to a Schedule C, there may be assets or income information for both the business name and the individual taxpayer. Keep in mind that when performing indirect methods of reconstructing income, the examiner must be prepared to determine the application of that unreported income (that is, where it was spent or otherwise disposed of) by performing an indirect method on the shareholder(s) or partner(s). Therefore, the more complete the search is upon both the entity and its owners, the more likely an understatement, if any, will be proven.

The following sources of information have been divided into two categories: internal and external. Internal sources are those available from within the IRS while external sources represent all others outside the Service. These sources provide information relative to income and assets of the taxpayer and may assist the examiner in the classification of a particular tax return. The examiner should keep in mind that some of the third party sources may vary from state to state relative to the actual information they have, or in the way they store it. Generally, one phone call to that source will enable the examiner to proceed with the information search from that particular party.

Internal Sources of Information

Information on Tax Return

In identifying audit potential by using figures per return for a comparative ratio analysis to industry averages, the examiner must be aware of the large variances in the industry. The tax return generally will describe the business activity as "car wash" but does not include a description of the facility (i.e. full service tunnel, self-service bays, and automatic bays). This information is necessary in ratio analysis of items (such as supplies, wages, purchases, and utilities) in that those and other items vary considerably, depending upon the facility.

Gross receipts will vary depending upon the facility, from self-service bays averaging \$1.75 per cycle to a full service tunnel which could range from \$5.00 to \$14.00 (i.e. per car wash). Many car washes issue and accept a variety of discount coupons which entitle the bearer to a discount ranging from \$1.00 off to a free wash. Often the gross receipts are reported at net after coupons and discounts which skew the income shown on the return. Also, while gross receipts may include vacuum, vending and other items sold or detailing services rendered which could skew

the gross receipts from the industry average, the agent will not know of their inclusion until the initial interview.

Water and sewer expense will vary based on whether the taxpayer has a well or town/city water and sewer hookups. With well water, there are no city charges for water use and generally no sewer charges either, as sewer charges are usually determined from the water meter. Reclaim systems also affect these expenses as water use is greatly reduced due to the recycling. Electricity expense will differ from location to location, according to the equipment being used. Self-service bays use the least amount of electricity, while the full service tunnels use the most. In addition, rates vary from town to town which will affect the dollar amount of the deduction per the return.

Cost of goods sold is presented in a variety of ways on car wash tax returns. Car wash purchases/inventories generally consist of soaps and chemicals. Purchases could also include other costs such as utilities, water, and sewer, as they can be considered costs of the product. Some taxpayers do not show any inventory because they consider it de minimis. Occasionally, no amounts appear in the cost of goods sold section, as they are reflected under "other deductions" in the general and administrative expense section of the tax return. These variables make ratio analysis of gross profit percentages impossible.

In addition, purchases of soaps and chemicals vary based on the type of facility. Self-service bays use considerably less chemicals than either the automatic bays or full service tunnels. Repair and maintenance expense is a constant and ongoing activity in any type of car wash. The amount expended will be directly related to the condition and use of building and equipment and the level of expertise of the owner.

External Sources

Registry/department of Motor Vehicles

Many states motor vehicle departments have a Special Procedures Section, perhaps associated with their Collection Division, which has the motor vehicle information on a database and is easily accessed by the Special Procedures employee. If this service is not available in the examiner's district, in most instances he or she may contact the registry directly. Data may be searched by an owner's name, driver's license number, social security number or license plate number of a particular vehicle.

The examiner can obtain a listing of all vehicles registered to that individual or entity and their date of purchase, latest renewal information, the lienholder or lessor, and the VIN. Also available is information such as the owner's, last known address as furnished by the party, date of birth and description of the individual. Often this information can lead to additional sources of income or other bank accounts (for example, the loan application from a lender, or the insurance policy which may list vehicles not currently registered, but insured).

State and Local Offices

The Secretary of State's Office has a record of all corporations and their officers which can be used to identify shareholders. The city or local town hall maintains a record of all "dba's" (doing business as) for the locality and will provide the owner of record for all unincorporated businesses.

Tax Assessor's and Collector's Offices

Real and personal property assessed values and tax bills are maintained at this level and contain information such as property descriptions, owners of record and address, appraised values and in the case of real property, the book and page number in the registry of deeds for the quitclaim deed of the current owner.

County Registry of Deeds

All real property is recorded at the Registry of Deeds either in the land court or records section. In most instances, the examiner will need to know the year of sale/purchase and the owner's name to search for property. Deeds reflect the buyer and seller name and address, the amount of consideration and the property's legal description. These documents provide information of asset transactions for a particular taxpayer and possible taxable transactions. The examiner may use this information or follow-up on third party sources discovered such as lenders and other parties, and find still other sources of unreported income. Also recorded in the Registry of Deeds are trust instruments, partnership agreements, leases, liens, and judgments which can also lead to ownership of other assets under yet another name or entity in which the taxpayer is involved.

Court Records

The courts maintain records which can provide valuable audit information, such as divorce settlements, probate matters, bankruptcy and other legal proceedings. Information relative to property transfers, assets, and other financial information of the parties may be found here.

Local Water Department

This department maintains records on water use, usually by the billing records. This will be helpful if the taxpayer does not keep water bills and the examiner needs to verify the expense or the number of gallons used during a particular time period. This party will also be able to furnish the examiner with information relative to the water pressure being furnished to the facility should it be needed for an indirect method.

Local Electric Company

As with the water department, information on electric usage may be retrieved from this source. This will be helpful should the examiner need to verify the electric expense deduction or ascertain the electric usage for an indirect method.

Soap/Chemical Manufacturers

These sources may be contacted should the examiner need information on total purchases made by the taxpayer. The manufacturer's representatives may be helpful in determining soap or chemical dilution rates or the number of vehicles serviced by a unit of their products should the examiner need this information when reconstructing income.

Equipment Manufacturers

These companies will be able to provide the examiner with specifics as to water usage and sometimes electrical usage for their equipment. There may be a number of factors which skew actual usages, especially if the taxpayer did not use the company's representatives to install the machinery, or did not abide by their installation requirements. However, this source can still provide the examiner with information which will be helpful in the examiner's gross income reconstruction.

The National Weather Service

The examiner may need to contact this agency to verify the taxpayer's records if they reflect that, for instance, the car wash was closed for a week due to inclement weather. Also, the examiner may need to retrieve information as to temperatures to verify the number of days the taxpayer's weep system was engaged.

Audit Techniques

Income - Gross Receipts

A car wash is a cash intensive business, therefore, it is important to perform an in-depth test of gross receipts.

Many taxpayers arrive at their gross receipts per the tax return by simply adding up deposits to their business bank account(s). Due to the cash intensive nature of the car wash business it would be easy for a portion of the taxpayer's gross receipts not to be deposited and, therefore, not reported.

The first test of the taxpayer's gross receipts should be a direct test of the taxpayer's gross receipts records. The following are various direct and indirect tests that may be useful in the examination.

Daily Sales Summary Sheets

Many full serve tunnel car wash businesses have employees and the owner/shareholder may require employees to complete a daily sales summary sheet at the end of their shift. These summary sheets usually itemize the number of cars washed, extras sold, and total monies

collected. The examiner should select a test period and tie in the total monies collected with the deposits.

Car Counters

Owners/shareholders sometimes install more than one car counter, particularly when they have employees, to ensure that employees are not misappropriating monies. The examiner can determine the reasonableness of the taxpayer's reported gross receipts by analyzing the car counter records maintained by the taxpayer.

Example 1

Total cars washed during the year per car counter records 45,500 times the average car wash price x \$ 6.00 (\$5.00 basic wash + \$1.00 menu options) equals an estimated Car Wash Gross Receipts \$ 273,000

Income from Self Serve Activities

Sales from self serve bays; vacuum and vending (air fresheners, polish, towels, etc.) may represent a substantial portion of the taxpayer's gross receipts. These sales have fewer controls than the full serve tunnel car wash sales. Generally, it is the owner/shareholder who empties the coins out of the machines and many times there are no records kept on the amount of money collected.

- a. If the self serve bays, vacuum and vending machines have counters and records are maintained, the examiner can analyze these counter records and determine the reasonableness of the taxpayer's income from self-service activities. (The examiner should use an analysis similar to the one shown above for car wash sales.)
- b. Also, most car washes have bill changers, where customers will convert dollar bills into quarters then use these quarters in the self-serve bays, vacuum and vending machines. These bill changers usually have counters. If the records are available the examiner may be able to use these records to perform another test of the taxpayer's income from self-serve activities.

It is important to note that there is no direct correlation between the amount of bills converted to coins and the amount of income generated by the business activities. The customer converting a bill into coins does not necessarily deposit all of the coins into one of the taxpayer's machines. Also, some customers may not use the bill changer if they already have enough coins to operate the taxpayer's machines.

During the initial interview the examiner can ask the owner/shareholder to determine the percentage of customers that use the bill changer but do not use the quarters in one of the taxpayer's machines, and to determine the percentage of customers that do not use the bill changer but do deposit coins into one of the taxpayer's machines.

Due to the estimates described above, this test of the taxpayer's self-serve activities income should be used as an indicator of unreported income when the taxpayer doesn't have any records and the examiner has to reconstruct income.

Example 2

Number of bills converted to coins per counters	\$950,000.00
Less: dollars converted but not deposited into one of the taxpayer's machines	(95,000.00)
Add: coins that didn't come from taxpayer's bill changer but were deposited into one of the taxpayer's machines	\$50,000.00
Estimated self serve activities income	\$905,000

Due to inadequate internal controls, all the car washes examined during this project required the use of indirect methods to test income.

During these examinations the team performed at least two indirect methods on the car wash business (primarily corporations) and the team also performed at least one indirect method on the shareholder's tax return.

On the car wash business, the team generally performed a bank deposit analysis and a consumption method, which is described later in this chapter.

Note: Due to the many variables present in the consumption methods, Counsel would not uphold a proposed adjustment solely based on a consumption method. Therefore, it is suggested that the consumption methods should just be used to show an indication of unreported income and not as the sole basis for a proposed adjustment.

On the shareholder's tax return a bank deposit analysis and/or a cash transaction analysis (Cash-T) were performed. The team concluded that any income probe of a car wash business should include an examination of the owner/shareholder's tax return. The audit procedures should include a bank deposit analysis, cash transaction analysis, and an evaluation of the owner/shareholder's standard of living. Form 4822, Statement of Annual Estimated Personal and Family Expenses, can be used to assist in this analysis.

Consumption Methods

The consumption methods described below reconstruct the taxpayer's income by determining the number of cars that were washed based on the amount of water, soap, or chemicals consumed.

The consumption formulas contain many variables and estimates which, if not accurate, can skew the results considerably. The team determined that the consumption methods should be used as an indicator of unreported income, when the taxpayer does not have any records and the examiner has to reconstruct the taxpayer's income. The team also concluded that another indirect

method should be performed on each taxpayer to ensure that the taxpayer's gross receipts are correct and that any proposed adjustment will be sustained at the Appeals and Counsel levels.

Water Consumption Method

The number of gallons of water used per cycle may be difficult to determine. It should be noted that there will rarely, if ever, be one specific value for this factor, therefore it will be necessary to compute a value which will represent an estimated number of gallons per cycle. There are, however, certain techniques which can be utilized to arrive at a figure which will represent a usable and relatively accurate number.

One technique is to be on site during the business day to inspect the operations while they are underway and read the water meter(s) as the cars are being washed. Taking a reading before and after a cycle is completed is the best way of determining the basic number of cubic feet used. The following are suggested techniques for reading water meter(s) and for otherwise determining the amount of water usage:

Take as many as 10 readings (or more as circumstances warrant) and fluctuate the number of cycles between readings. For example, take one or two readings before and after one cycle, a few more readings before and after 3 or 4 cycles, and still another sample of readings after 6 or 7 cycles have passed. This insures that the examiner has sufficient data to arrive at a reasonably accurate value.

Water consumption on the meter is always measured in cubic feet rather than gallons. Once the number of cubic feet has been determined, multiply the number of cubic feet times 7.48 to arrive at the equivalent number of gallons used.

The number of gallons will fluctuate based upon the services ordered by the customer. For example, a basic wash may use "X" gallons whereas "super deluxe" type option may use more water during the wash or rinse cycle.

The number of gallons of water used per cycle may be difficult to determine. It should be noted that there will rarely, if ever, be one specific value for this factor, therefore it will be necessary to compute a value which will represent an estimated number of gallons per cycle. There are, however, certain techniques which can be utilized to arrive at a figure which will represent a usable and relatively accurate number.

For self service bays, the water use depends on the customer's use of the "wand". They may desire more soap and less water than the customer before or after them. However, throughout the industry there are certain parameters and maximums which can be quantified. The end result is that most customers end up using roughly the same amount of gallons of water per self serve cycle.

In addition to the meter reading and bucket filling techniques, the equipment manufacturer may have basic parameters regarding water usage of their equipment, and may be even more specific if their company or an authorized representative performed the installation. When contacting the

manufacturer, it is recommended to have all information relative to installation (particularly with respect to any variations from the manufacturer's specifications). Also, contacting the local water department to retrieve information as to the water pressure being supplied to the facility will assist the manufacturer in determining number of gallons per cycle.

Water loss through the weep system. The weep system is a mechanism which allows water to drip or "weep" throughout the system to prevent water from freezing in the pipes during the winter. Once the examiner determines the rate of water loss from the system, and also has verified that this weep water is in fact lost and not reused in the system, he/she needs to determine just how often the system was turned on during the year. During the initial interview, the taxpayer should have told the examiner the temperature at which the system is engaged. Usually the temperature ranges from 34 to 40 degrees Fahrenheit.

Other water losses that may have to be accounted for include, washing down tunnels and parking lots, free and rewashes, washing machines for towels and rest room facilities.

Water Consumption Analysis Formula

The consumption formulas contain many variables and estimates which will skew the results in either direction; therefore they should only be used as an indicator in testing gross receipts. In addition to a consumption formula, one or more traditional methods of testing income should be performed (bank deposit analysis, cash transaction analysis, source and application of funds, and/or a net worth method). This is necessary to ensure that the examiner's income adjustment and/or civil fraud penalty will be sustained at both the Appeals and Counsel levels.

The first factor the examiner needs to determine is the total number of gallons used in a particular tax year by the taxpayer.

The examiner can usually obtain the water meter readings from the water bills. The water meter readings are expressed in cubic feet (or hundred cubic feet) and must be converted into gallons in order to use this value in the water consumption formulas. Also, the water meters are usually read in 6 month intervals but are rarely read by the water company on the first and/or last day of the tax year. Therefore the examiner may need to annualize the usage by using those readings closest to the tax year dates.

Other items needed such as number of gallons per cycle, water losses, prices per cycle and vacuum and vending sales will be gathered at the initial interview and on-site testing of water meters.

By taking the Ending Reading from the water bills and subtracting the beginning Reading you will get the amount of water used for that period of time. Then:

- A. Take the number of months between Readings and divided into the amount of water used to get the Average Monthly Use
- B. Once you figure out the Average Month Use times it by the months In Tax Year (12 unless short year)

- C. The result is the Estimated Cubic Ft. Per Year
- D. To get the Gallons Per Cubic Feet, times the result by 7.48. This would equals the
Estimated Total Gallons Used This Year
Less Gallons Lost To Other Uses
Equals Gallons Used For Car Washes
- E. Divide the Gallons Used For Car Washes by the Gallons Per Cycle gives you the number
Cycles Per Year
- F. The calculate Gross Receipt by:

Lowest Or Average Price Per Cycle times
 Wash Receipts as Reconstructed \$
 + Income From Other Sources(E.G. Vending) +
 + \$ Gross Receipts As Reconstructed \$ +
 - Gross Receipts Per Return (\$)
 Difference Under/(Over) Reported \$
 =====

NOTE:

- a. Winter months are usually busier for car washes. Therefore to obtain an accurate average monthly usage a twelve month reading period should be used.
- b. By using the lowest price (not including menu options), the gross receipts per return should always be greater than the formula result. If the average price is used the formula result should be closer to gross receipts per the tax return, if no under/overstatement exists.

Soap/Chemical Consumption Method

One of two scenarios arises when using this consumption method:

- a. Taxpayer has been able to give the examiner an estimate of how many cars can be serviced by a certain measure of soap or other chemical (i.e.: 700 cars per 55 gallon drum), or
- b. Taxpayer has been unable to furnish information relative to any soap or chemical used on a consistent basis on each auto.

The soap or chemical manufacturer can provide guidelines as to the recommended dilution rate for a particular product. Each chemical is accompanied by a suggested dilution rate, and is most often listed right on the container. However, there is usually a significant fluctuation between recommended and actual dilution rates, based upon such factors as owner preference, hardness and pressure of the water, nozzle size, etc. The manufacturer can generally give an estimated range of the minimum and maximum dilution rates or the number of cars per a certain measure of product. Once this information is obtained, the examiner may take an average of the variables given and use that figure to complete the indirect method to reconstruct income.

In addition, considerations similar to those noted in the water consumption method may be relevant (e.g., estimates of chemical usage any equipment manufacturer)

Soap/Chemical Consumption Analysis Formula

The consumption formulas contain many variables and estimates which will skew the results in either direction; therefore they should only be used as an indicator in testing gross receipts. In addition to a consumption formula, one or more traditional methods of testing income should be performed (bank deposit analysis, cash transaction analysis, source and application of funds, and/or a net worth method). This is necessary to ensure that the examiner's income adjustment and/or civil fraud penalty will be sustained at both the Appeals and Counsel levels.

With soap or chemical consumption formulas it is necessary to determine a reasonable estimate of the number of cars washed by a drum (generally 55 gallons) of soap or other chemical.

In addition, the beginning and ending inventory counts must be used in the calculation. If the counts are not available a reasonable estimate must be used.

To formula basically is:

- A. Use the Number Of Drums Used This Year and multiply by the Number Of Gallons Per Drum
- B. The Number Of Gallons Used This Year is then multiplied by Number Of Ounces Per Gallon
- C. Number Of Ounces Used This Year Times the number Of Cars Washed Per Ounce
- D. Finally, multiply the Number of Total Cycles during the Year by the price of a cycle to find the gross receipt from car washes.
- E. Example:
Lowest or Average Price of Cycle
Times price of a Wash Receipts as Reconstructed \$
Plus Income form Other Sources (i.e. vending) + \$
Gross Receipts as Reconstructed \$
less Gross Receipts per Return (\$)
Difference Under/ (Over) Reported \$

Note:

(a) By using the lowest price (not including menu options), the gross receipts per return should always be greater than the formula result. If the "average" price, which is an estimate, is used the formula result should be closer to gross receipts per the tax return, if no under/overstatement exists.

Expenses

Audit results among the tax returns examined for this project were compared to identify trends, if any, within the industry. The expenses listed below are so noted because the team has found adjustments in these areas. However, this list is not designed to preclude an examiner from

considering all expenses on the tax return, but these in particular should be addressed when determining scope and depth.

Wage Expense - Employee vs. Independent Contractor

The follow is a brief outline of the law regarding employment status and employment tax relief. It is important to note that either worker classification -- independent contractor or employee -- can be valid.

If the requirements of section 530 are met, a business may be entitled to relief from federal employment tax obligations. Section 530 terminates the businesses but not the worker's employment tax liability, including any interest or penalties attributable to the liability for employment taxes.

In determining a worker's status, the primary inquiry is whether the worker is an independent contractor or an employee under the common law standard. Under the common law, the treatment of a worker as an independent contractor or an employee originates from the legal definitions developed in the law of agency -- whether one party, the principal, is legally responsible for the acts or omissions of another party, the agent -- and depends on the principal's right to direct and control the agent.

Guidelines for determining a worker's employment status are found in three substantially similar sections of the Employment Tax Regulations: sections 31.3121(d) -1, 31.3306 (i) -1, and 34.3401 (c) -1, relating to the Federal Insurance Contributions Act (FICA) , the Federal Unemployment Tax Act (FUTA) , and federal income tax withholding. The regulations provide that an employer-employee relationship exists when the business for which the services are performed has the right to direct and control the worker who performs -the services. This control refers not only to the result to be accomplished by the work, but also to the means and details by which that result is accomplished. In other words, a worker is subject to the will and control of the business not only as to what work shall be done but also how it shall be done. It is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if the employer has the right to do so. To determine whether the control test is satisfied in a particular case, the facts and circumstances must be examined.

The Service now looks at facts in the following categories when determining worker classification: behavioral control, financial control and relationship of the parties.

Behavioral Control

Facts that substantiate the right to direct or control the details and means by which the worker performs the required services are considered under behavioral control. This includes factors such as training and instructions provided by the business. Virtually every business will impose on workers, whether independent contractors or employees, some form of instruction (for example, requiring that the job be performed within specified time frames). This fact alone is not sufficient evidence to determine the worker's status. The weight of "instructions" in any case

depends on the degree to which instructions apply to how the job gets done rather than to the end result.

The degree of instruction depends on the scope of instructions, the extent to which the business retains the right to control the worker's compliance with the instructions, and the effect on the worker in the event of noncompliance. The more detailed the instructions that the worker is required to follow, the more control the business exercises over the worker, and the more likely the business retains the right to control the methods by which the worker performs the work. The absence of detail in instructions reflects less control.

Financial Control

Facts on whether the business has the right to direct or control the economic aspects of the worker's activities should be analyzed to determine worker status. Economic aspects of a relationship between the parties illustrate who has financial control of the activities undertaken. The items that usually need to be explored are whether the worker has a significant investment, unreimbursed expenses, whether the worker's services are available to the relevant market, the method of payment and opportunity for profit or loss. The first four items are not only important in their own right but also affect whether there is an opportunity for the realization of profit or loss. All of these can be thought of as bearing on the issue of whether the recipient has the right to direct and control the means and details of the business aspects of how the worker performs services.

The ability to realize a profit or incur a loss is probably the strongest evidence that a worker controls the business aspects of services rendered. Significant investment, unreimbursed expenses, making services available, and method of payment are all relevant in this regard. If the worker is making decisions which affect his or her bottom line, the worker likely has the ability to realize profit or loss.

Relationship of the Parties

The relationship of the parties is important because it reflects the parties' intent concerning control. Courts often look to the intent of the parties; this is most often embodied in contractual relationships. A written agreement describing the worker as an independent contractor is viewed as evidence of the parties' intent that a worker is an independent contractor -- especially in close cases. However, a contractual designation, in and of itself, is not sufficient evidence for determining worker status. The facts and circumstances under which a worker performs services are determinative of a worker's status. The designation or description of the parties is immaterial. This means that the substance of the relationship governs the worker's status, not the label.

Officer Compensation

This expense may warrant examination from two different perspectives. The deduction may range from being excessively high to nonexistent. In each case, an examiner must consider the facts and circumstances including, but not limited to, the expertise of the individual, the officer's

involvement in the business, how the salary was determined, and the profitability of the company, the shareholder loan account and the dividend history.

Repairs

Car wash equipment, whether new or used, generally requires ongoing maintenance and repair to keep it in good working order. Therefore, the repair expense may be significant should it represent these upkeep expenses. The amount of the deduction will also vary depending upon whether the shareholder(s) or hired trades people performed the work.

An examiner should inspect invoices and canceled checks for this expense and to insure that there are no capital expenditures deducted currently.

Rents

Several issues may arise when examining this expense. Typically, the shareholder owns the land and building, leasing it to the car wash entity. This is referred to as self-rented property. In this situation, rent payments are expensed on the car wash tax return and net rental income or loss is reported by the shareholder.

With self-rented property, special rules apply with respect to the passive activity rules under IRC 469. Generally, losses will be passive, but income will not. Due to the complexity of the passive activity rules, the lessors often report the net rental income or loss incorrectly and adjustments may be necessary.

Fair rental value is another issue in self rental situations. Rents in excess of fair rental value may be reclassified as dividend distributions to the shareholder whereas rents below fair rental value may be adjusted on both entities. Per I.R.C. section 482, the shareholder would be treated as though it made a capital contribution to the corporation equal to the bargain element, and the corporation would get a rental deduction equal to the arm's length rate. The shareholder should include in rental income an amount equal to this arm's length rate.

To determine fair rental value, an examiner may contact a local public appraiser, real estate agent or search the internet. Lease payments made to companies concerning the installation of car wash equipment may also be deducted as rents. In some instances the lease payments represent payments toward the actual purchase (not lease) of that equipment, in which case the lease payments may be capitalized and the equipment depreciated. Documents to examine include the lease agreements, deeds for the land and building and sales/lease contracts for equipment.

Depreciation

This deduction most often represents depreciation of the building and/or the equipment when the business entity owns the assets. Most car wash buildings, both self serve bays and full service tunnels, are considered real property and assigned to specific class lives and depreciation methods under ACRS and MACRS. Certain car wash tunnels, usually associated with gasoline stations, have a shorter class life. Equipment generally falls into 7 year (MACRS) class life.

The examiner may want to inspect the contracts relative to the purchase and/or construction of the buildings (including electrical and plumbing components), purchase and installation of equipment, and any other documents relative to asset acquisitions.

Insurance

This expense reflects premiums paid for the taxpayer's insurance coverage for health, life, fire, liability, business interruption, workmen's compensation and other miscellaneous policies.

The policies reflect items such as the assets owned, their cost or value, projected sales figures, financing information, payroll and employee data, etc. By inspecting these policies, an examiner may discover acquisitions and/or disposals of assets not reflected on the tax return, premiums paid for unallowable coverage, personal expenses, and information useful in income reconstruction, payroll data and many other examinations worthy issues. Of particular note are health benefits paid by an S-Corporation for the shareholders.

Balance Sheet

Audit results among the tax returns examined for this project were compared to identify trends, if any, within the industry. The balance sheet items listed below are so noted because the team has found adjustments in these areas. However, this list is not designed to preclude an examiner from considering all balance sheet items on the tax return, but these in particular should be addressed when determining scope and depth.

Shareholder Loans

These accounts represent transactions between the corporation and the shareholder(s). Audit potential in these accounts is generally high, particularly with closely held corporations. In most cases, each transaction during the year should be detailed separately. An item listed as an advance paid to the shareholder may represent a personal expenditure paid on the shareholder's behalf. An advance that is not a bona fide advance should be treated as a distribution under I.R.C. section 301. Relative to an advance received from the shareholder, an issue of thin capitalization may be present. As with any shareholder loan, the arm's length nature of the loan must be addressed. Many times the interest charged is either below fair market value rate, or nonexistent. In this situation, if a valid loan exists, an adjustment is made by imputing interest as if a fair rate were charged and paid (IRC 7872).

Inspect the loan agreements, advance and repayment history, debtor's ability to pay, collateral pledged, legal enforceability of the agreement, etc. Still other factors to consider include the amount of officer compensation, dividend history, significance of retained earnings and capital accounts.

Loans Between Affiliates

These accounts represent transactions between the corporation and affiliated corporations (brother/sister, etc.). These loans generally have high audit potential and should be scrutinized.

Audit techniques, similar to the ones described under shareholder loans (above), should be performed.

Buildings and Other Depreciable Assets

In addition to reviewing allowable class lives and methods (explained earlier under EXPENSES), verifying the depreciable basis of assets may lead to significant adjustments. In the car wash industry, since some owners are plumbers, electricians or contractors, they take an active part in the construction of the building and/or installation of the equipment. An examiner may discover that part of the depreciable basis represents the value of these owners' labor, which is unallowable.

Also, an examiner should review employees' salaries. At times, the employees perform the construction or installation work. Salaries attributable to those services should not be deducted as a current expense; they should be capitalized and added to the depreciable basis of the asset.

Documents to examine include purchase and sales agreements, construction contracts, financing arrangements and invoices to determine the allowable depreciable basis.

Initial Interview and Information Document Request

The initial interview is perhaps the most critical part of the examination process and whenever possible, should be conducted with the proprietor (or shareholder) personally as opposed to a representative. Usually it is this taxpayer (or sometimes the on-site manager) who has the first hand knowledge of the day-to-day operations of the business. This may be the examiner's only opportunity to meet with the taxpayer, therefore the examiner must obtain as much information as possible at this time about both the financial and day-to-day operations of the business and taxpayer personally. This is done to get an overall economic picture of the business entity and owner/shareholder to determine if the funds available can support both the business expenses and apparent life-style.

Additionally, the interview should be conducted on the business premises so that a tour of the business may be performed at the same time. Many times the examiner may not clearly understand statements made by the taxpayer relative to cash flow or operations and, by being on-site; the taxpayer can actually demonstrate their answers to the examiner's questions. This will help to avoid misunderstandings and give the examiner a clearer picture of exactly how the business is operated. A tour of the business site may also lead the examiner to possible sources of unreported income, such as vacuum sales, vending machines, public telephone commissions or rental income from other parts of the building occupied by other tenant businesses.

Below, the examiner will find an interview questionnaire which encompasses questions specific to this business and the owner/shareholder which should be addressed. This will answer many questions well in advance of the actual examination, making the entire process flow more smoothly. This questionnaire is provided as a guideline and the examiner should make changes where necessary. Also, it is important to use follow-up questions as they may lead the examiner

to potential adjustments or unreported income. Again, the questionnaire is a guideline and should be used accordingly.

In some circumstances, the responsibility for handling and reporting income may be delegated to a trusted employee with little or no safeguards or internal controls to protect the owner. In this situation, the examiner should be aware that misappropriation of funds and other assets may occur at this level, before the owner/ shareholder's involvement. Again, during the initial interview phase of the examination, the examiner should pay careful attention to the taxpayer's answers to questions regarding internal controls. The examiner may find it necessary to ask questions directly to that trusted employee and, if warranted, to conduct an income probe of that employee.

In corporate examinations verifying sources of income of the owner/shareholder at an early stage is critical. If an understatement is discovered, and the taxpayer has already stated that their sole source of income is the corporate entity, the examiner will be able to demonstrate that the likely source of the unreported income represents diverted corporate funds. Therefore, the examiner may be able to adjust the corporation's gross receipts, and also treat the unreported income as a distribution of funds subject to Internal Revenue Code section 301 and 316 (dividend, return of capital or capital gain income).

Potential Interview questions relating to Car Wash:

1. How Much Of The Owner's/Shareholder's Time (%) Is Actively Spent On The Business:
2. How Many Locations:
3. How Many Bays:
4. What Services Are Provided? I.E. What Method For Washing, Vacuuming,
5. Vending Machines, Scenting, Detailing)
6. What Is The Price Scale:
7. Do You Charge More For A Particular Type Of Vehicle:
8. What Are the Percentages Regarding the Different Services (E.G. How Many Purchase Basic Wash, Deluxe, Or Extras)
 - o Provide Estimates:
9. Do You Have "Busy Periods" (Summer Vs. Winter, Weekdays Vs Weekends, Nights Vs Days)
 - o What Is Your Reasoning For These Patterns:
10. Is There A Water Reclaim System:
11. Does The Business Use Public Or Private Water Sources:
12. How Many Water Meters Are On The Property (If More Than
13. What Functions On The Premises Does Each Register--E.G. For Restrooms,
14. For The Bays, Etc):
15. How Many Gallons Of Water Are Used Per Basic Cycle, Per Extra Rinse,
16. Per Deluxe Wash:
17. Describe The Types Of Soaps, Waxes, And Other Chemicals Purchased And
18. The Quantity Of A Single Unit: (I.E. 55 Gal Drum, 100 Lb Tub)
19. Are Any Of These Chemicals Used On Every Car In A Consistent Manner:
20. How Many Cars Can Be Serviced From A Single Unit Of These Products:

21. How Often Do You Wash Down Bays Or Tunnels,
22. How Long Does It Take And
23. How Many Gallons (Approx) Does It Take:
24. Do You Have A "Weep" System
 - If So, At What Temperature Does The System Engage,
 - How Many Gallons Of Water Are Used Per Any Measured Time Frame,
 - And Is The Weep Water Tied Into A Reclaim System.
25. Were There Any Significant Leaks Or Other Water Losses
 - If Yes, Can They Be Verified:
26. Is There Any Information Available Relative To Electric Kwh Use Per Cycle Or Multiple Of Cycles:(Mfg Of Equip. May Provide This Info)
27. Is The Equipment Commercially Produced, Or Is It Custom Made:
28. If Commercially Produced, Who Is The Manufacturer:
29. When Was The Equipment Purchased, Installed, And What Depreciation Methods:
30. Who Does The Maintenance/Repair Work:
31. Car Counter Records _____
32. Pre-Numbered Coupons _____
33. Are There Separate Tallies For Each Collection Bay:
34. How Are Coupons, Rewashes, And Discounts Accounted For In The Books:
35. Are The Coins Deposited Or Exchanged In The Coin Changer:
36. Where Are The Monies Kept After Collection,
 - If In A Safe, Where is it
 - And Is A Cash Register Maintained,
 - And If So, Who Takes The Readings
 - And Are They Retained:
37. Are There Car Counters
 - If So Are They Recorded –
 - What Information Do They Compile (E.G. Basic Washes, Options, Rewashes, Amt. Due)
 - If Car Counters Are Maintained, Are They Reconciled To Receipts:
38. When And Where Are Expenses Recorded:
39. How Is Petty Cash Handled:
40. Accept Credit Cards (M.C., Visa, American Express)
41. Do You Barter: (Furnish Services In Exchange For Goods And Services :)?

Initial Document Request for Corporate Car Wash Returns

Information Requested

Water and sewer bills which reflect monthly meter readings for the year under audit

Electric bills which reflect monthly meter readings for the year under audit

Regarding equipment - Provide the date, cost, name, and address of the manufacturer, model or serial number, and name and address of the installer. If the equipment was not installed to the manufacturer's specifications, be able to discuss any significant variations (i.e. nozzle size, pipe fittings, etc.).

Provide a list of all soaps, waxes, drying agents and other chemicals purchased as well as the quantities on hand at the beginning and end of the year
Car counter records, if applicable

Provide all information regarding issuance and acceptance of discount coupons

Case Studies

Introduction

The following case studies represent common and/or unique issues discovered during the team's examinations of car wash businesses. It is important to note that the law applied in these case studies was based on facts and circumstances pertaining to actual cases. This section is presented to assist examiners in identifying and developing potential issues that may exist in the car wash industry. These case studies are for reference only and should not be cited to taxpayers or their representatives as the basis for proposed adjustments.

- Gross Receipts - Traditional Indirect Methods
- Gross Receipts - Water Consumption Method
- Gross Receipts - Soap/chemical Consumption Method
- Inventory
- Distribution versus Wages
- Net Income from Self Rented Property
- Rents Paid in Excess of Fair Rental Value
- Lease versus Purchase
- Depreciation of Car Wash Tunnels
- Health Benefits Paid by S-Corporation
- Imputed Interest on Below-market Loans
- Loan versus Dividend

Case Study 1

Gross Receipts - Traditional Indirect Methods

Facts

The taxpayer is a corporation which operates a tunnel car wash. The taxpayer also receives revenues from the self-service vacuums and sundry items sold in the vending machines (towels, air freshener trees, etc.). The taxpayer calculated gross receipts by totaling deposits for the year, stating that all receipts were deposited into the corporate checking account. There were no other records for income. The shareholder does not provide services to the taxpayer.

The taxpayer used well water; therefore the number of gallons used during the year was not ascertainable. A chemical consumption formula and a bank deposit analysis were performed to test the taxpayer's reported income. Neither of these methods indicated an understatement of income.

To further examine gross receipts, a bank deposit analysis and a source and application of funds were performed on the shareholder's tax return (complete with Form 4822 for Estimated Personal Living Expenses). An understatement of income resulted from these methods. The shareholder made random cash deposits (\$12,222) during the year into the personal bank account and could not identify the source of those deposits.

The shareholder reflected various sources of income on the tax return. It is the duty of the car wash business to keep appropriate records. If these records are inadequate and the shareholder cannot identify the source of the unreported income, the Service may justifiably assume that the unreported income came from the car wash business and assess the corporation accordingly. This will result in taxation at both the corporate and shareholder level assuming there are sufficient earnings and profits.

Summary of Indirect Method Results

Method	Understatement
Corporate:	
1) Chemical Consumption	\$ 0.00
2) Bank Deposit Analysis	\$ 0.00
Shareholder:	
1) Bank Deposit Analysis (Specific Deposits)	\$ 12,222.00
2) Source & Application of Funds (Incl. Form 4822 Est. Personal Living Exp.)	\$ 14,864.00

Because the bank deposit analysis understatement could specifically identify the unreported income in question without addressing any estimated personal living expenses, the proposed increase to the shareholder's income was \$12,222.

This case study demonstrates the necessity of performing an examination on both the car wash business and those individuals who have the responsibility and autonomy of handling the cash and documenting sales. In most cases this will be the shareholder(s) but sometimes an unrelated party such as an on-site manager may be involved. Often time's diverted funds in a cash intensive business do not appear in the bank accounts of the corporation (or Schedule C). Therefore, it is important that the examiner perform an examination of the individual(s) tax return.

Also, this case study demonstrates the inability to propose an adjustment to gross receipts based solely on a consumption method formula. The formulas contain many variables which may skew the results in either direction; therefore they should only be used as a guide in testing gross receipts. In this case, even though the consumption formula did not indicate any unreported income, the examination of the shareholder's tax return uncovered an understatement, the most likely source being the car wash business. If it was ultimately determined that the source of the

understatement was the car wash business, the unreported income would be dividend income not subject to SECA.

Case Study 2 Gross Receipts - Water Consumption

Facts

The corporation's tax year under audit is from February 1, 2006 to January 31, 2007 (0701). The closest water readings available were on March 2, 2006 and March 2, 2007. The taxpayer estimated that each cycle used approximately 38 gallons of water, and the average price per cycle was \$6.00. Water losses during the year approximated 48,000 gallons due to the weep system, washing down tunnel and parking lot, free and rewashes, washing machine for towels and the restroom facilities. The taxpayer also estimated that receipts for vacuums and vending were \$13,000. The corporate bank deposits were used to report gross receipts and no other record of sales was kept.

Gross Receipts - Water Consumption

Date/Reading 03/02/06		438,404
Date/Reading 03/02/07		(311,900)
Difference (cubic feet)		126,504
Estimated Cubic Ft. Per Year 126,504 x Gallons Per Cubic Feet times 7.48		
Est. Total Gallons This Year		946,250
Gallons Lost to Other Uses	(48,000)	
Gallons Used for Car Washes	898,250	
Gallons Per Cycle	38	
Number of Cycles Per Year 23,638 x Average Price Per Cycle times \$6.00		
Tunnel Receipts as Reconstructed		\$141,828
Plus Estimated Vac. & Vending Income		\$13,000
Gross Receipts as Reconstructed		\$154,828
Gross Receipts Per Return		(\$144,828)
Difference Under/ (Over) Reported		\$ 10,000

Even though the results indicate unreported income by the taxpayer, the examiner cannot use just this method as an accurate reconstruction of income, only an indicator. There are many estimates within the formula such as: number of gallons lost, amount of vacuum and vending income and average price per cycle.

To further examine gross receipts, a bank deposit analysis was performed on the corporation which reflected an understatement of income due to math errors in the taxpayer's books and records.

Summary of Indirect Method Results

Method Under/ (Over) statement

Corporate:

1. Water Consumption \$ 10,000.00
2. Bank Deposit Analysis \$ 10,046.00

Due to the above results, the proposed increase to the corporation's gross receipts was \$10,046.

Case Study 3
Gross Receipts - Soap/Chemical Consumption

Facts

The corporation's facility is a full serve tunnel car wash. The tax year was from January 1, 2007 to December 31, 2007 (0712). The chemical (a drying agent) was used in every cycle and 1 ounce serviced 2 cars. No physical inventories were taken. The taxpayer's charge for a basic wash was \$5.50. The shareholder does not provide service to the car wash.

Date Purchased # of Drums (55 gal. per drum)

1 drum on 03/18/07;

1 drum on 05/02/07;

1 drum on 08/23/07;

1 drum on 12/23/07;

So the total drum purchased is 4.

Although the last drum was purchased just prior to year end, the first purchase of the year was on March 18th. The purchase pattern reflected an average purchase of once every three months (this was in addition to the oral testimony of the taxpayer). For purposes of estimated total chemical consumption for the tax year, 4 full drums were considered used by the taxpayer.

Difference Under(Over) Reported		
Number of Drums Used This Year	4 drums	
Number of Gallons Per Drum	55 gallons	
Number of Gallons Used this Year	4 times 55 equals 220 gallons	

Number of Ounces Per Gallon	64 ounces	
Number of Ounces Used this Year	220 gallons times 64 ounces equals 14,080	
Number of Cars Per Ounce	2	
Total Cycles During the Year	28,160	
Lowest Price for a Cycle	5.00	
Wash Receipts as Reconstructed		\$140,800
Plus Income from Other Sources (i.e. vending)		+ \$16,500
Gross Receipts as Reconstructed equals		\$157,300
Gross Receipts Per Return		(\$147,950)
Difference Under(Over) Reported		\$9,350

In this case, the formula result indicated an understatement. A bank deposit analysis on the corporation did not indicate an understatement. A source and application of funds and a bank deposit analysis of the shareholder's return revealed an understatement of income larger than the formula result. The car wash business was determined to be the most likely source of the understatement.

Summary of Indirect Method Results

Method	Understatement
Corporate:	
1) Chemical Consumption	\$ 9,350
2) Bank Deposit Analysis	\$ 0.00
Shareholder:	
1) Bank Deposit Analysis (Specific Deposits)	\$ 10,299
2) Source & Application of Funds (Incl. Form 4822 Est. Personal Living Exp.)	\$ 10,061

Due to the above results, the proposed increase to the corporation's gross receipts was \$ 9,350 and a constructive dividend of \$9,350 was included in the shareholder's income.

Case Study 4 Inventory

Facts

The taxpayer is a corporation which operates a tunnel car wash. In addition to the income received for the car wash services, the taxpayer sells various items such as fragrance trees, car wax, towels, and car rugs. The taxpayer also retains soaps and chemicals on hand for use in the car wash. The taxpayer maintained an inventory listing prepared at year-end which indicated the inventory on hand totaled \$19,569. Although the taxpayer maintained an inventory, the taxpayer did not reflect the amount in its cost of goods sold. The taxpayer stated that they did not include inventory since the amount did not fluctuate significantly from year to year.

IRC Section 446(a) provides that taxable income is to be computed under the method of accounting regularly used by the taxpayer to compute income on its books. However, if the method does not clearly reflect income the Commissioner has the authority under IRC Section 446(b) to change the taxpayer to a method which does clearly reflect income. Inventory must be kept in all cases in which the production, purchase or sale of merchandise of any kind is an income-producing factor per Treas. Reg. 1.471-1.

Treasury Regulations Section 1.446-1(c) describes various permissible methods of accounting. If inventories are necessary, Regulation 1.446-1(c) (2) (I) requires the use of the accrual method for sales and purchases. The fact that year-end inventory values are immaterial does not constitute an exception to the regulation. See *Knight-Ridder Newspapers v. United States*, 743 F 2d 781, 11th Cir 1984.

Because the sale of merchandise is an income producing factor, the examining agent may change a method of accounting as part of an examination. The change must be implemented with an I.R.C. section 481 adjustment. The year of change is generally the earliest taxable year under examination and the entire I.R.C. section 481(a) adjustment must be taken into account in computing taxable income in the year of change. Section 481(b) may limit the amount of tax arising from the I.R.C. section 481(a) adjustment. The examining agent must also compute an adjustment for the year of change and subsequent taxable years to reflect the use of the new method of accounting in those years. While, Rev. Proc. 92-20, 1992-1 C.B. 685, does not apply to changes made as part of an examination, it permits taxpayers under examination to make a voluntary change during specified window periods. If one of the windows applies, the year of change may not be a taxable year under examination and the taxpayer may be entitled to spread the I.R.C. section 481(a) adjustment. No windows applied in this case, thus, the full I.R.C. section 481(a) adjustment must be taken into account in the earliest year under examination. The adjustment to inventory in this case was as follows:

	Cost of Goods Sold	
	Per Return	As Adjusted
Beginning Inventory	\$ 0	\$ 17,340 *
Purchases	34,850	34,850
Goods Available	34,850	52,190
Ending Inventory	0	19,569
Cost of goods sold	\$ 34,850	\$ 32,621

* Amount determined per taxpayer records/reconstruction from prior year's records

Total adjustment

IRC section 481(a) \$ 17,340 (Full amount of beg. inventory)

IRC section 481(b) \$ 2,229 (Difference between \$34,850 and \$32,621) is \$ 19,569

Case Study 5

Distribution Versus Wages

Facts

The taxpayer operates a car wash which files as an S-Corporation. The sole shareholder of the corporation is an officer of the corporation, but does not earn a salary. The corporation makes a distribution to the shareholder/officer, without withholding income tax or FICA tax. The shareholder makes all management decisions regarding the car wash. In addition, the shareholder performs all the record keeping functions. The taxpayer employs four individuals to help in the day-to-day operation of the car wash. The shareholder received a distribution in the amount of \$45,000 during the tax year.

When a sole shareholder of a Subchapter S-Corporation performs management duties but does not receive a salary, the issue is twofold: (1) whether the Sub S-Corporation is illegally avoiding FICA, FUTA and income tax withholding requirements; and (2) whether the distribution is really compensation for services within the purview of I.R.C. section 61(a) (1), or whether it (or any portion thereof) is an I.R.C. section 1368 distribution.

Internal Revenue Code Section 3121(a) - FICA and Section 3306(b) - FUTA define "Wages" as all remuneration for employment. Section 3121(b) and Section 3306© define "employment" as any service, of whatever nature, performed by an employee for the person employing him. Section 3121(d) (1) and Section 3306(I) define "employee" to include any officer of a corporation.

Treasury Regulation 31.3121(d)-1(b) states that generally, an officer of the corporation is an employee of the corporation. This general rule applies to the case study because the shareholder/officer makes all management decisions and performs all record keeping functions. However, an officer of a corporation who as such does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is considered not to be an employee of the corporation.

Revenue Ruling 74-44, 1974-1 CB 287 (involving small business corporation that paid dividends instead of salaries.) states that, "dividends that two sole shareholders of an electing small business corporation arranged to receive instead of reasonable compensation in the same amounts for services they performed constituted 'wages' for which the corporation was liable for the taxes imposed by the FICA and FUTA and the withholding of income tax."

In *Joseph Radtke, S.C. vs United States*, 895 F2d 1196 (7th Cir. 1990), the S-Corporation was not entitled to a refund for FICA and FUTA taxes assessed on "dividends" paid to its sole shareholder. The shareholder received only dividends and no salary. The court noted that an employer should not be permitted to evade FICA and FUTA by characterizing all of the employee's remuneration as something other than wages.

Revenue Ruling 82-83, 1982-1 CB 151 provides that a corporation whose officers perform functions within the scope of their duties as corporate officers is not entitled to relief under section 530 of the Revenue Act of 1978.

In a case where distribution from an S-Corporation is properly deemed a distribution with respect to stock rather than a salary, section 1368 will determine the proper tax treatment of such distribution.

Under the facts of this case study, the shareholder of the S-Corporation clearly performed more than nominal services for the corporation. Therefore, the \$45,000 distribution constituted wages subject to employment taxes.

Case Study 6

Net Income from Self Rented Property

Facts

The taxpayer operates a tunnel car wash. The taxpayer pays rent to the 100 percent shareholder for the use of the building in which the car wash is located. Inspection of the shareholder's Schedule E revealed that a net profit was incurred from the rental. The net income was classified as income from a passive activity and was utilized to offset passive activity losses from other activities.

IRC Section 469(c) (2) states that passive activities include any rental activities. Treasury Regulation 1.469-2(f)(6) provides that the amount of the taxpayer's net rental activity income for the taxable year is treated as not from a passive activity if the property is rented for use in a trade or business activity in which the taxpayer materially participates for the taxable income. This section applies to income only.

Since the shareholder is renting property to a corporation in which he/she materially participates, all the income derived from the rental is treated as nonpassive and cannot be used to offset the passive losses from the shareholder's other activities.

Case Study 7

Rents Paid in Excess of Fair Rental Value

Facts

The taxpayer is a corporation that operates a car wash business in the State of Massachusetts. The sole shareholder owns the building that the taxpayer's business is operated out of; therefore

the taxpayer is paying the sole shareholder rent. The taxpayer was paying the shareholder \$150,000 in rent each year.

The shareholder purchased the land and constructed the building two years earlier (land costs = \$113,000, building costs = \$150,000, total costs = \$263,000). Based on the lease agreement, the taxpayer is responsible for leasehold improvements, repairs, etc.

IRC Section 162(a)(3) allows a deduction for "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

Although it is not directly stated in IRC Section 162(a) (3), it is implied and the courts have held that only "reasonable" rents are an allowable deduction.

“Reasonable” rents have to be determined based on the each case’s facts and circumstances particularly when the lessee and lessor are not bargaining at arm’s length.

In *S & S Meats Inc. v. Commissioner*, T. C. Memo 1979-163 the fair market value of a building and equipment were determined using the replacement cost approach. Under that approach, fair market value was computed by determining the replacement cost of property for physical depreciation. Upon the determination of fair market value, no further adjustment was made for depreciation or obsolescence.

Agent applied the court’s method mentioned above and arrived at the following adjustment.

Adjustment	
FMV of Property *since the property was built recently, agent determined that its costs = its FMV	\$263,000
Adjusted Fair Market Value	\$263,000
Reasonable Return on Investment	15%
Reasonable Annual Rent Expense	\$39,450
Rent Expense per Tax Return	\$150,000
Adjustment	\$110,550

Amounts that are paid in excess of "reasonable" rents are disallowed from the corporate tax returns and would represent constructive dividends on the shareholder’s tax return (provided there are adequate earnings and profits).

Due to the control that a sole shareholder has over a corporation, monies paid by the corporation to the sole shareholder must be evaluated based on its "substance" versus its "form".

Based on agent's evaluation it was determined that the taxpayer deducted rents paid to the sole shareholder in excess of "reasonable" rents.

The taxpayer will be allowed a deduction for the "reasonable" portion of the rent payments made to the shareholder per IRC Section 162(a) (3).

Case Study 8

Lease Versus Purchase

Facts

Taxpayer X is a sole proprietorship. Taxpayer X entered into a contract with an independent leasing company concerning the installation of car wash equipment in Taxpayer X's car wash building. The leasing company will supply the funds to install the car wash equipment and retain legal title to the equipment. Taxpayer X will make lease payments for five years and at the end of five years the taxpayer will purchase all of the car wash equipment for one dollar. Taxpayer X is deducting the lease payments on the car wash equipment as rent expense.

Court cases and IRS rulings have reached determinations on whether a lease is a "valid" lease based on the substance of the lease and not the form of the lease. (See *Lockhart Leasing Co. v. U.S.*, 446 F.2d 269 (10th Cir. 1971))

The presence of one or more of the following factors may be evidence of a sale as opposed to a lease according to Rev. Rul. 55-540, 1955-2 C.B.39:

1. Portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee.
2. The lessee will acquire title upon the payment of a stated amount of "rentals" which under the contract he is required to make.
3. The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum to be paid to secure the transfer of title.
4. The agreed "rental" payments materially exceed the current fair market value. This may be indicative that the payments include an element other than compensation for use of the property.
5. The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made.
6. Some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest.

The following are potential tax consequences to the "lessee" if the lease is determined to be in substance a sale of property according to Rev. Rul. 72-408, 1972-2 C.B. 86.

1. The lessee is not entitled to rental deductions.

2. The basis of the property in the hands of the lessee is the sum of all amounts payable over the term of the agreement that are considered to be payments for the purchase of the property, to the extent such amounts do not represent interest or other charges.
3. The lessee is entitled to depreciation deductions.
4. The lessee is entitled to deduct all ordinary and necessary expenses paid or incurred in respect of the property.
5. The lessee is entitled to deduct any portion of the "rent" that represents unstated interest.
6. The lessee is entitled to deductions for state and local taxes imposed with respect to the property.

Based on the facts and circumstances of this case it has been determined that Taxpayer X has in substance purchased the car wash equipment, therefore Taxpayer X cannot deduct lease payments as rent expense and is allowed to depreciate the cost of the property using MACRS.

Case Study 9

Depreciation of Car Wash Tunnels

Facts

The taxpayer constructed a drive through car wash structure. The facade of the structure was brick concrete which contained four walls and a roof. The interior of the structure housed the main car wash frame which was made out of steel. The car wash structure also contained two offices. The two offices contained a desk, chair, computer, paintings and file cabinets. The offices were separated from the car wash frame by a wall. The exterior brick facade enclosed the two offices and the car wash frame and equipment. The taxpayer depreciated the car wash structure utilizing a recovery period of 15 years. The taxpayer cited Revenue Procedure 87-56, 1987-2 C.B. 674, as the authority for utilizing a 15 year recovery period.

Revenue Procedure 87-56 sets forth class lives for a wide variety of business activities and is used in conjunction with MACRS to determine proper depreciation recovery periods.

With respect to the MACRS depreciation the issue is whether the car wash structure is a building, as described by Revenue Procedure 87-56, under Asset Class 57.1 or whether it is an excluded building as defined in Treasury Regulation Section 1.48-1(e) which should be depreciated over 31.5 years as non residential real property (39 years for property placed in service after May 12, 1993).

Treasury Regulation 1.48-1(e) defines the term, "building", as generally any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display or sale space. Such term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations and stores.

The national position is that the reference to "car wash buildings" in the Asset Class 57.1 of Rev Proc 87-56 does not exclude car wash buildings that are not connected to petroleum distributing

stations. Asset Class 57.1 is applicable to all car wash buildings with respect to taxpayers that are in the business of providing car wash services. The 15 year recovery period was correct.

Examining agents should also consider whether the uniform capitalization rules of I.R.C. section 263A apply. These rules may apply, for example, if a car wash acquired property for resale. See, IRC 263A (b) (2); Treas. Reg. 1.263A-1(a) (3) (iii) and 1.263A-3.

Case Study 10

Health Benefits Paid by S-Corporation

Facts

The taxpayer is an S-Corporation that operates a tunnel car wash. There are two shareholders each owning fifty percent of the stock of the corporation. During the examination period, the S-Corporation paid all the health insurance premiums of its two shareholders.

IRC Section 1372 provides that an S-Corporation is treated as a partnership for fringe benefit purposes and any two percent or greater shareholder is treated as a partner. A two percent shareholder is defined as any person who owns on any day during the taxable year of the S-Corporation, more than two percent of the outstanding stock or stock possessing more than two percent of the total combined voting power of all the corporate stock.

Revenue Ruling 91-26, 1991-1 C.B. 184 provides that accident and health insurance premiums paid or furnished by an S-Corporation to or for the benefit of its 2-percent shareholder-employees, in consideration for services rendered, are treated like guaranteed payments under IRC Section 707(c). Therefore, the premiums are deductible by the corporation under IRC Section 162, subject to the capitalization rules of IRC section 263, and includable in the shareholder-employee's gross income under IRC Section 61. The premiums are not excludable from the shareholder-employee's gross income under IRC Section 106; however, if the requirements of IRC Section 162(l) are met, the shareholder-employee is allowed a deduction to the extent provided by IRC section 162(l).

The Self-Employed Health Insurance Act, Public Law 104-7, 109 Stat. 93, which was signed by the President on April 11, 1995, changed section 162(l). The Act increased the amount of the deduction to 30 percent for years beginning after 1994 and extended the deduction permanently by striking subparagraph (6), which provided that section 162(l) did not apply to any taxable year beginning after December 31, 1993.

NOTE: IRC Section 1372 does not identify or define the specific fringe benefits to which the section applies. The legislative history suggests that IRC Section 1372 was intended to govern the following statutory fringe benefits:

1. The \$50,000.00 income exclusion for employer provided group term life insurance under IRC Section 79(a).
2. The \$5,000.00 exclusion for employer provided death benefits provided under IRC Section 101(b).

3. The IRC Section 106 exclusion for employer provided coverage under an accident or health plan.
4. The IRC Section 105 exclusion for payments under employer accident and health plan for medical care, permanent loss or loss of the use of a member or function of the body.
5. The IRC section 119 exclusion for employee meals and lodging furnished for the convenience of their employer.

Case Study 11

Imputed Interest on Below-Market Loans

I. Loan to Shareholder

Facts

The taxpayer is a closely-held corporation which operates a tunnel and self serve car wash. The corporation is owned 100 percent by Mr. X. The balance sheet reflected a deemed loan to shareholder in the amount of \$95,000. There was no activity in the account during the tax year. Although the taxpayer had loan agreements, there was no interest stated on the loan.

IRC Section 7872 requires the Service to impute interest on certain loans bearing no interest rate or interest at a rate which is less than the Applicable Federal Rate. Section 7872 recharacterizes a below-market loan as two transactions:

1. An arm's length transaction in which the lender makes a loan to the borrower in exchange for a note requiring the payment of interest at the Applicable Federal Rate, and
2. A transfer of funds by the lender to the borrower ("imputed transfer").

The timing and characterization of the amount of the imputed transfer are determined in accordance with the substance of the transaction. Generally, the imputed transfer of foregone interest for demand loans is considered to take place on December 31.

In this case, the loan is a corporation-shareholder loan. The imputed transfer is treated as a distribution of money (characterized according to IRC Section 301 or in the case of an S-Corporation, IRC Section 1368). The corporation would be treated as receiving interest income and the shareholder would be treated as paying an interest expense. Interest expense deductibility is determined in accordance with Treasury Regulation 1.163-8T.

For tax year 1992, the interest calculation is
 $\$95,000 \times 4.98\% = \$4,731$

*The deemed interest rate for a below-market loan is determined in accordance with IRC Section 7872 and the Regulations thereunder and IRC Section 1274.
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Since in this case the principal amount of the loan was outstanding for the entire calendar year, a blended annual rate can be used. For 1992, the blended annual rate is 4.98% as published in Revenue Ruling 92-50, 1992-2 CB 205.

Accordingly, the corporation would report interest income in the amount of \$4,731. The shareholder would report a distribution of \$4,731 and would be allowed a deduction for interest expense of \$4,731 if otherwise deductible under Regulation Section 1.163-8T.

II. Loan from Shareholder

Facts

The taxpayer is a closely-held corporation which operates a tunnel and self serve car wash. The 100 percent shareholder loaned \$95,000 to the corporation in prior tax years. No money was loaned to the corporation during the tax year. No interest was charged.

The law is the same as above with the exception of the tax treatment. The imputed transfer from the lender-shareholder is treated as a contribution to capital of the borrower-corporation. The corporation would be treated as paying an interest expense and the shareholder would be treated as receiving interest income.

In the case above, the corporation would be allowed a deduction for interest in the amount of \$4,731. The shareholder would report interest income in the amount of \$4,731 and would report a capital contribution to the corporation in the amount of \$4,731.

Depending on the facts and circumstances what is stylized as a shareholder loan may be characterized as a capital contribution by shareholder, and what is stylized as a repayment of a loan from a corporation may be more properly characterized as a dividend.

III. Indirect Loans between Affiliated Corporations

Facts

The taxpayer is a closely-held corporation which operates a tunnel car wash owned 100 percent by Mr. X. During the examination of the books and records, a loan to an affiliate in the amount of \$95,000 was noted. The loan was made in prior tax years to a related corporation which provides medical services. The related corporation was also owned 100 percent by Mr. X. No interest was charged to the corporation. The development of facts revealed that there was no business purpose for the loan and the shareholder personally benefited from the transfer.

If a below-market loan is made between two parties, and based on all the facts and circumstances, the effect of the loan is to make a distribution of money or the loan is otherwise attributable to the relationship of the lender or borrower to the indirect participant, the loan restructured as two or more successive below-market loans ("deemed loans") for the purposes of IRC Section 7872, as follows:

- A deemed below-market loan made by the named lender to the indirect participant, and
- A deemed below-market loan made by the indirect participant to the borrower.

IRC Section 7872 is applied separately to each deemed loan, and each deemed loan is treated as having the same provisions as the original loan. Therefore, in this case, there would be a deemed loan to shareholder from the lender (car wash) to the shareholder (indirect participant) followed

by a second deemed loan from shareholder (indirect participant) to the borrower (medical service).

Under certain circumstances what is stylized as a loan may be characterized as a capital contribution by shareholder, and what is stylized as a repayment of a loan from a corporation may be more properly characterized as a dividend.

Case Study 12

Loan Versus Dividend

Facts

The taxpayer is a corporation which operates a tunnel car wash. The balance sheet of the corporate return reflects a Loan To Stockholder Account. The corporate officer is the sole stockholder of the corporation. The account balance was \$20,000 at both the beginning and end of the taxable year.

The Loan To Stockholder Account represents a corporate disbursement of \$20,000 which was made to the sole stockholder in the prior year. The power of attorney provides a copy of the corporate minutes which state that the Board of Directors ratified the loan on January 1st of the current year. The corporate minutes also state that the loan is required to be paid over 48 months with a market rate of interest. The stockholder used the proceeds of the loan to make improvements to his principal residence. The power of attorney provided a note which was executed on January 1st of the prior year and an amortization schedule with a market rate of interest. There were never any repayments made on the loan despite the existing debt instruments. The power of attorney stated that due to the decline in the economy the corporate officer was not able to draw sufficient compensation from the corporation to make the loan payments. The power of attorney did not make any year end adjusting entries relating to loan or the interest on the loan. The power of attorney stated that the stockholder would begin making repayments on the loan when the economy improved and sufficient compensation could be drawn from the corporation allowing the corporate officer the financial wherewithal to make the payments. The corporation has been in existence for twelve years. The corporation has never declared or paid a dividend. The balance in the cash account on December 31, of the current year is \$155,000. The balance of Retained Earnings on December 31, of the current year is \$187,000.

The corporate officers' Form 1040 reflected \$25,000 in portfolio income, and taxable income of \$135,000.

IRC Section 316(a) defines the term "dividend", as any distribution of property made by a corporation to its shareholders out of its accumulated and current earnings and profits.

IRC Section 301(c) defines the treatment of a distribution of property from a corporation to a shareholder. The portion of a distribution defined as a dividend under IRC Section 316(a) is included in Gross Income. The portion of the distribution which is not a dividend is applied first against adjusted basis of the stock, and to the extent that the distribution exceeds the adjusted basis of the stock, such amount is treated as a gain from the sale or exchange of property.

Whether or not payments to stockholders of a closely-held company are loans or constructive dividends is decided on whether or not the collective facts add up to debt or dividend. (*Williams v. Commissioner*, 627 F. 2d 1032 (10TH Cir. 1980)).

The taxpayer does not dispute the nature of the transaction which created the Loan To Stockholder Account but refutes the examiner's contention that the withdrawal is a constructive dividend. The taxpayer argues that the corporate minutes and the debt instrument establish a declared intent to repay and the failure to execute the repayment demands detailed in the corporate minutes and the debt instrument was attributable to a slow economy. The taxpayer further argues that the true characterization of a distribution as either a dividend or a loan should be determined by the intention of the parties at the time the loan was made, and should not be altered by the subsequent events. Finally, the taxpayer stated that the amount is a loan because the corporation would never declare or pay a dividend in adverse economic conditions.

With respect to the debt versus dividend issue, the courts have looked to a number of test factors in deciding the issue. These factors are as follows:

1. The taxpayer's significant control and dominion over the corporation
2. The corporation's dividend history
3. The size of the withdrawals
4. Whether or not the corporation imposed a ceiling on the amounts that might be borrowed
5. Whether there were definite maturity dates
6. Whether there were attempts to force repayment
7. Whether there was an intent or attempt to repay
8. The shareholder's ability to liquidate the loan
9. The corporation's impressive earned surplus
10. The failure to execute notes

The taxpayer's determination that the loan is valid only addresses the factors of, "intent", and "note execution" and makes no reference to the other factors stated above. The taxpayer's declared intent to repay is insufficient if it is inconsistent with the undisputed facts indicating the intrinsic economic nature of the transaction (*Fin Hay Realty Co. v. United States*, 398 F 2d 694 (3d Cir. 1968)). The self serving declarations of the taxpayer must be balanced against the surrounding circumstances (*Williams v. Commissioner*, 627 F 2d. at 1032.).

The shareholder exercised control over the corporation's assets to his personal benefit and interest. The fact that the loan proceeds were used to improve personal assets and not business assets is evidence that an economic benefit was received by the shareholder. In *Wortham Machinery Company v. United States*, 521 F. 2d 160, 164 (10th Cir. 1975), the court stated that, "A constructive dividend is paid when a corporation confers an economic benefit on a stockholder without expectation of repayment". The taxpayer's reliance on an economic decline as the only obstacle preventing repayments is not only inconsistent but provides further evidence that the withdrawal was a dividend and not a loan. The corporation's large cash balance coupled with significant Retained Earnings, was indicative of the corporation's ability to pay a dividend. The fact that this was more attributable to the corporation's prior earnings than current earnings does not change the characterization of the withdrawal as a dividend. IRC Section 316(a),

defines distributions as dividends where they are made out of either current or accumulated earnings. The taxpayer stated that the withdrawal was a loan because the corporation would never declare or pay a dividend during adverse economic conditions. This statement has little relevance where the corporation also failed to declare or pay dividends during the prosperous economic period of the early and middle 1980's.

With a corporation which has numerous stockholders with varying interests, the arm's length relationship between a shareholder and a corporation is conducive to having transactions whose form mirrors its substance. Where the corporation is closely held, however, and the same person occupies both sides of the bargaining table, form does not necessarily correspond to the economic nature of the transaction. Therefore, the process of drawing any meaningful conclusions from evaluating the test factors pertaining to the corporation's limitation on the amounts borrowed and the corporation's efforts to enforce repayment, would require the debtor/creditor relationship to extend beyond a situation where the corporation is nothing more than an extended creature of the stockholder, see *Alterman Foods Inc v. U.S.*, 505 F. 2d 873 (5th Cir. 1974).

The fact that the stockholder provided a note with a stated interest rate and a definite maturity date are indicative of a debt transaction especially where the execution of the instrument is commensurate with the advancement of the funds. However, in *Tyler v. Tomlinson* 414 F.2d 844 (5th Cir. 1969), the court recognized that it "requires more than a declaration of intention to create an indebtedness and more than the existence of corporate paper encrusted with the appropriate nomenclatural captions". Subsequent to the execution of the debt instrument there was no further acknowledgment of the stockholder's indebtedness by either the corporation or the stockholder which could have been validated by interest payments in accordance with the terms of the debt instrument.

Where corporate advances are made to the corporation's sole stockholder, courts look with great care to the surrounding facts and view with some suspicion, declarations of intent which have the effect of maximizing the tax benefit of the stockholder (*Alterman Foods Inc. v. U.S.*, 505 F.2d at 873).

The examiner concluded that facts pertaining to the \$20,000 stockholder loan on the corporate balance sheet of the car wash were characteristic of a dividend distribution and could not be altered merely by the existence of a debt instrument. In arriving at this conclusion the examiner considered the test factors, stated above, utilized by the courts in litigating the debt verses dividend issue. The test factors which were applicable to this case study are as follows:

1. The stockholder's significant control and dominion over the corporation
2. The corporation's failure to declare and pay dividends in prosperous economic periods
3. The corporation's impressive retained earnings balance
4. The stockholder's failure to make repayments
5. The stockholder's personal use of the proceeds
6. The stockholder's failure to pay or the corporation's failure to accrue interest

These factors override the taxpayer's avowed intention to repay and established a pattern of conduct which is inconsistent with a debtor/creditor relationship. Accordingly, the examiner included in the taxable income of the stockholder in the year under audit a dividend distribution in the amount of \$20,000.

Glossary

Back Operation- The area where cars are prepared for entry into the car wash line (aerial lowered, interior vacuumed, floor mats washed, etc.).

Base Crew - The permanent, full-time employees.

Bay- The area or stall where a car is washed in a coin-operated, self-service car wash.

Blower - The dryer, the last mechanical operation in a tunnel operation.

Brush Unit- Two, three or five large revolving brushes that clean the car as it is pulled through the wash line by the conveyor.

Customer Concourse - An area or walkway running parallel to the wash line where customers can walk along and watch the cars being processed. It is usually air-conditioned and ends at the cashier's desk.

Detailing - The final operation before the driver gets into his car and drives away. Windows are cleaned inside and out, any water left in cracks or other recesses is wiped off, the chrome areas are polished, etc. This is a manual operation. There are also stand alone detailers who perform this service independent of the car wash.

Dilution Rate - The ratio of water-to-chemical of a mixed solution (e.g. 6 oz. chemical to 55 gal. water). This information may be useful in determining how much chemical is applied on a per car basis, should the examiner use a chemical consumption method of reconstructing income.

Hydrominder- This device automatically mixes a liquid chemical or soap with water to a predetermined dilution rate. The water flows through the unit and siphons the liquid chemical concentrate through a metering tip and also maintains a level of ready to use solution. If the taxpayer knows the setting on the hydrominder, this information may be useful in determining how much chemical is applied on a per car basis, should an examiner be using a chemical consumption method to reconstruct income.

Magazine- Off-street area where customers wait in line for their turns in the car wash. Also called automobile-stacking area.

Mitters - Employees who go over each car with hand brushes or large mittens to clean areas the brushes can't reach. Also, cloth "mittens" on the actual car wash equipment are also called mitters, which are used in place of human mitters.

Power Wash Unit - A machine that mixes detergent and warm water and feeds it to an applicator under pressure, loosening the dirt before the car reaches the brushes.

Pre-rinse - A preliminary rinse that cools the car if necessary (for instance, if the car has been standing too long in the hot sun) and begins to soften the dirt.

Reclaim System- A recycling system for water which cleans and filters dirty water to be reused in the wash cycle. A reclaim system may recycle anywhere from 60% to 100% of the water used.

Rollover- Equipment used in the automatic self-service bays which actually rolls back and forth over the automobile while washing under high pressure.

Stacking- See Magazine.

Steam Cleaning Gun- A "gun" at the end of a hose that carries steam and detergent solution for cleaning floor mats, bumpers, and grills. Also wheels if there is no special wheel-washing equipment.

Steamer- Equipment that develops steam and mixes it with detergent as fast as needed. It is safer than a boiler.

Sudser- Equipment that dumps soapsuds on the car as it goes through the wash line. The principal value of this process is in the eye appeal it creates.

Titration Test- A chemical testing procedure which measures the density of a chemical/water (or soap/water)/solution.

Vacuum Unit- A 5 to 10 horsepower vacuum with 2 large hoses for cleaning the inside of a car.

Walkway - Same as Concourse.

Wash Line- The working area through which the cars are carried by conveyor through the tunnel.

Wand- Hand held equipment generally used in the self serve bays for soap and water at high pressure.

Weep System - Thermostatically controlled system which allows water to drip from the nozzles to prevent freezing during the winter. Generally, the systems are set to engage when the temperature drops below 34 to 40 degrees Fahrenheit, depending upon the owner's specifications. When reconstructing income using water consumption, the examiner must consider water lost from this system.