

Cash Intensive Businesses Audit Techniques Guide - Chapter 15 - Laundromats

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Overview

Coin Laundromats or self service laundry facilities offer coin-operated clothes washing and drying machines to the public. Laundromats are conveniently located in shopping centers, college dormitories, apartment buildings, and travel centers. Laundromats can either be operated by the owner or a hired attendant.

The machines in a Laundromat are usually coin operated but some newer models are equipped to accept cards. Washer and dryer units vary in terms of load capacities and operating efficiencies, with newer models designed to reduce water, electricity and natural gas consumption.

Laundromats also have additional coin-operated vending machines that dispense laundry products such as soap, fabric softener and dryer sheets. Vending machines for soft drinks and snacks may also be available. Most washers, dryers and vending machines require coins, so it is customary for a laundromat to have a change machine that converts currency into coins.

Some Laundromats may also offer additional services such as a wash-dry-fold service in which the Laundromat attendant will wash, dry and fold clothes for a fee based on either the weight or the type of item.

National surveys conducted by the Coin Laundry Association indicate a wide range of usage for the equipment. The industry terminology for individual equipment usage is "cycles per day," or "turns per day (TPD)." These designations refer to the average number of times each machine is used per day. While this statistic varies widely, the average for washing machines is generally from 3 TPD to as high as 8 TPD. The primary factors that affect TPD include population demographics, capacity and quantity of the washers, as well as vend prices.

Dryer income is usually expressed as a percentage of overall income. Generally, dryer income varies between twenty-five and fifty percent of total washer and dryer income. The primary factors that affect dryer income include the total wash poundage, vend prices of both washers and dryers, heating efficiency of dryers, total number of dryers in relation to washers, and dryer size and capacity.

Income

A Laundromat's main source of income is from coins deposited into the washing and drying machines. Income may also be generated from vending laundry products, soft drinks and snacks, or other laundry-related services provided by the Laundromat.

Laundromats are a cash-intensive business with limited or ineffective internal controls over receipts. Although currency change machines do not produce income, they are an important consideration when evaluating internal controls and understanding the cash flow of a Laundromat. For example, when determining gross receipts, a laundromat owner may not count the coins deposited in the washer, dryer or vending machines. Instead, the owner may take the coins from these machines to refill the change machines. As a result, gross receipts may be

understated because change machines usually do not have the capacity to hold all coins collected from the laundry and vending machines.

Examiners should review deposit slips to see if both currency and coins are being deposited. Since coins require sorting, counting and wrapping, the taxpayer may only include the currency from the change machines as income causing gross receipts to be understated.

In situations where income is underreported, audit trails are usually insufficient to determine the amount of underreporting. Some taxpayers may not make daily or regular trips to the bank as would be necessary in order to maintain adequate internal controls over cash, and may instead use the cash to avoid reporting the income. For example, prior to making a bank deposit, the taxpayer and/or family members may spend some of the receipts to pay either business or personal expenses. The taxpayer may only write checks for non-business mortgage, utilities or credit account payments, and use cash (currency and/or coins) to pay for day-to-day personal living expenses. It is possible for a taxpayer to live a cash existence where virtually everything is paid in cash.

It is extremely important for the examiner to identify all sources of income including nontaxable sources. Examiners should review deposits and canceled checks from all of the taxpayer's bank business and personal accounts.

A taxpayer will usually disclose all cash business expenses, but may not disclose all the personal expenses that were paid using cash from receipts that were not included in gross receipts. It is also possible for a taxpayer to pay for personal living expenses by credit card which will require the examiner to determine the source of personal credit card payments. If the taxpayer cannot show that personal living expenses were paid by check or by credit card, then it is likely that the personal expenses were paid using cash. If paid by cash, the examiner will need to ensure that such payments were made from receipts that have been properly reported as income.

The IRS has the authority to reconstruct income by any reasonable means pursuant to Section 446(b) of the Internal Revenue Code if it is determined that the taxpayer's method of accounting is inadequate. However, the IRS must first show that the taxpayer's method of determining income is inadequate before a reconstructive method can be utilized. As such, it is essential for the examiner to document the inadequacy or adequacy of the taxpayer's income records. A taxpayer's method of determining income can be deemed inadequate if the conditions below exist.

- Records were either not maintained or not available for review
- Cash T indicates a cash shortage with no explanation from the taxpayer
- Taxpayer's business ratios vary from industry averages with no explanation from the taxpayer
- Actual business operations indicate more income than what was reported
- Reported receipts cannot be tied to the books because they were not deposited or cannot otherwise be verified

The examiner should consider photocopying the records when the records are deemed to be inadequate. If the records are deemed to be inadequate, the examiner must fully document and clearly demonstrate why he/she believes the records do not adequately reflect income.

Examiners must specifically ask interview questions and complete the minimum income probes to ensure that a quality examination is conducted timely. (IRM 4.10.4.3) The examiner must use his or her best judgment after considering all of the facts and circumstances. For example, the examiner can use the utility consumption analysis (as discussed below) to estimate gross receipts. Such analysis may indicate that income is understated. However, the utility consumption analysis is not absolute. As such, the examiner cannot simply rely on the utility consumption method analysis and ignore the taxpayer's books, records and testimony.

Initial Interview and Information Document Request

The initial interview is very important when examining a laundromat establishment. Prior to reviewing taxpayer records, it is critical that the examiner document the taxpayer's responses during the initial interview, as well as all responses to any required follow-up questions.

Examination procedures should be modified in a manner that will best address the actual facts and circumstances of the taxpayer's business situation. The examiner must make a determination regarding the taxpayer's knowledge of the Laundromat and equipment, and must fully understand the extent of the taxpayer's involvement in the day-to-day business operations.

Although there are benefits to conducting the examination at the business site, it is not always practical. At a minimum, it is recommended that the examiner visit the Laundromat with the taxpayer and/or representative. It is essential that the answers to the examiner's inquiries are provided by the owner or the person who is most knowledgeable about the operations of the Laundromat.

The examiner must unequivocally establish the amount of personal and business cash at the beginning of the taxpayer's tax year, the amount of personal and business cash at the end of the taxpayer's tax year, and all non-taxable sources of income such as tax refunds, insurance proceeds, gifts or cash hoard.

The examiner must absolutely account for all the washing and drying machines by manufacturer, model and manufacturer's specifications pertaining to load capacity and efficiency rating. Information for each unit must include any specialized features, actual use, or configuration that affects the published manufacturer's efficiency rating. Some major commercial laundry equipment suppliers include, Huebsch, Milnor, PWS-The Laundry Company, Speed Queen, and Wascomat Laundry Equipment.

Water, electricity, and natural gas consumption that is not directly consumed by washing and drying machines cannot be used when reconstructing income using the utility consumption analysis. As such, the examiner must consider all information regarding utility (water, electricity, natural gas) consumption for general business lighting, heating and restrooms.

Utility Consumption Analysis

If the examiner has a reasonable indication that unreported income exists, and the taxpayer's books and records are deemed inadequate, the utility consumption analysis can be used to reconstruct income.

Although it is best to use the taxpayer's actual equipment and performance, the washing and drying machine standards provided by the manufacturer can be used to reconstruct income. Every washer and dryer model is manufactured to use a specific amount of gallons of water for each load washed or kilowatts of electricity or cubic foot (1000 BTU) of natural gas for each load dried respectively. Thus, the number of loads washed and dried can be estimated based on the amount of utilities consumed.

Washer models can be either top load or front load. Front load models use less water and are more efficient. For example, the water consumption for a Speed Queen vended top load washer with a 2.8 cubic foot basket is 23.7 gallons of water per cycle. Similarly, one with a 3.16 cubic foot basket consumes 29.7 gallons of water per cycle. In contrast, a front load model with a 2.84 cubic foot basket consumes between 12.8 to 14.8 gallons of water per cycle.

Dryer models can be single pocket or stacked (two dryers). Larger dryers are referred to as tumblers. For example, Speed Queen single pocket models usually have an 18 pound or 7 cubic foot capacity. Whereas, tumblers have 25, 30, 35, 50, 55 or 75 pound capacities. Dryers can be electric and natural gas models.

Electric consumption for these dryer capacities is 12, 21, 24, 27, 30 and 30 kilowatts per cycle respectively. Natural gas consumption for these dryer capacities is 64,000, 73,000, 90,000, 112,000, 130,000 and 165,000 BTU's per cycle.

All relevant information should be considered because the actual performance of the taxpayer's machines may vary from the published manufacturer's specifications. For example, the taxpayer's machines may be configured to reduce water consumption or the actual consumption may be affected by how the machines are used by the customer. Nonetheless, these specifications can be obtained from either the taxpayer or by researching the manufacturer on the internet. Kilowatt and BTU conversion tools are also available on the internet.

The process of reconstructing income works best when the taxpayer is actively involved in every step of the calculation, provides the best information available, and is allowed to correct inaccurate data. The objective is to arrive at the best estimate of income when records are either inadequate or otherwise unavailable.