



Cash Intensive Businesses Audit Techniques Guide - Chapter 15

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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.

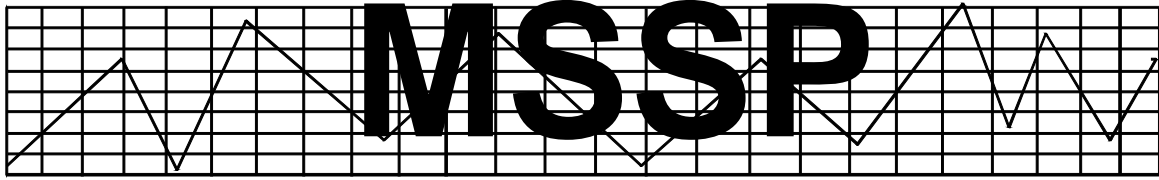
Dryer models can be single pocket or stacked (two dryers). Larger dryers are referred to as tumblers. For example, Speed Queen single pocket models usually have an 18 pound or 7 cubic foot capacity. Whereas, tumblers have 25, 30, 35, 50, 55 or 75 pound capacities. Dryers can be electric and natural gas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

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Market Segment Specialization Program



The Laundromat Industry

The taxpayer names and addresses shown in this publication are hypothetical. They were chosen at random from a list of names of American colleges and universities as shown in *Webster's Dictionary* or from a list of names of counties in the United States as listed in the *United States Government Printing Office Style Manual*.

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Foreword

The water consumption analysis based on water usage is a common sense approach to estimate revenue of a laundromat. In addition, specialists in the laundromat industry use the water consumption ideology to verify claims of gross receipts by laundry owners attempting to sell their businesses. Remember, water is a consumable product that goes somewhere, either to produce income or for other uses which we call waste.

Articles in trade publications, letters from tax preparers, and other comments by practitioners have been critical of the analysis. None, however, have questioned the basic approach. They have questioned such things as water waste and gallons of water per wash load.

It is critical to realize that the consumption analysis is no cure-all. You cannot simply use it and ignore the books and records of the taxpayer, interview questions regarding income and other areas of a quality examination. In conjunction with the consumption analysis, it may be worthwhile in certain cases to use observation, an industry expert, or a traditional indirect method of reconstructing income. In this regard, we believe that the water consumption analysis if used appropriately can serve as a basis for reconstructing the number of loads washed at a laundromat and therefore, the unreported income from the operation of a laundromat. We realize that use of the water consumption analysis will only provide a range as to the amount of omitted laundromat income and is not as exact as the more traditional methods of reconstructing income (for example, bank deposit method). However, it is recommended because it is a common sense approach that is understood by both taxpayers and examiners alike.

NOTE: The IRS Restructuring and Reform Act of 1998, Section 3412, prohibits the use of financial status examination techniques to determine the existence of unreported income **unless** the IRS has a reasonable indication that there is a likelihood of unreported income.

This guide is written with the assumption that there is a reasonable indication of unreported income.

The Laundromat Industry

INTRODUCTION

The water consumption analysis is a methodology that gives an indication that a problem exists. However, the consumption analysis is no cure-all. You cannot simply use it and ignore the books and records of a taxpayer, interview questions regarding income and other areas of a quality examination. The examiner must use his or her best judgment after considering all of the facts and circumstances.

Section 446 of the Internal Revenue Code states that if the taxpayer's method of accounting is inadequate, the IRS can reconstruct income. We must show that the taxpayer's method is inadequate. The water consumption analysis is then used as the vehicle for reconstruction. This guide is written with the assumption that there is a reasonable indication of unreported income.

By examining the quantity of water consumed, the number of loads washed and dried during the year under audit can easily be reconstructed. This is possible because for each washer model, there is a standard amount of water consumed per load washed.

Industry standards, taxpayer information and other estimates are used in the calculations to estimate revenue of the taxpayer. See Exhibit 5 for industry standards used.

PRE-AUDIT

Exhibit 1 is an example of an Information Document Request (IDR). Exhibit 2 is a sample Laundromat Questionnaire. Review these exhibits to determine what information the taxpayer should bring to the initial interview, for example, books and records to verify income, bank statements, utility bills, etc.

INITIAL INTERVIEW

The initial interview is very important for a laundromat and documentation is critical. The information listed in the sample exhibits should provide almost all the information and documents needed to audit a laundromat. This information should be gathered up front.

It is important to tailor the audit to the taxpayer's specific facts and circumstances. The examiner should establish the taxpayer's level of knowledge regarding the machines and the involvement in day-to-day business operations. Does the taxpayer have first-hand knowledge of laundromat operations? Does the taxpayer do his or her own repairs to the machines? How involved is the taxpayer in the business?

It is beneficial to hold the audit at the laundromat business location so that the information relating to the machines, load prices, other income sources, etc., can be verified. If the audit is not held at the laundromat, it may be necessary to visit the laundromat if the information provided appears inconsistent or unreliable. Refer to "Customer Use Percentages and Visiting the Laundromat" section later in this ATG.

If the consumption analysis shows there is no significant underreporting and other indications of underreporting are not present, the examiner can curtail the audit.

CASH FLOW AND BOOKS OF A LAUNDROMAT

A laundromat is generally a cash business with little audit trail. Typically, a laundromat owner does not count coins to determine gross receipts. Instead, to determine gross receipts, the owner counts the paper money coming from bill changers without the necessity of dragging heavy coins to the bank. This procedure can lead to underreporting of gross receipts because the change machine usually does not have the capacity to hold all coins collected from the laundry machines. The excess coin income may therefore not be reported.

In cases where income is underreported, there is often no audit trail to determine if the funds were spent for personal or business expenses. It appears that some taxpayers do not make as many trips to the bank as would seem necessary to keep the cash under control. Before it is time to make a bank deposit, the taxpayer and family may spend cash on business and personal expenses. The taxpayer often only writes checks to pay large bills such as the mortgage. The taxpayers and their families may lead a cash existence.

With this in mind, it is extremely important for the examiner to tie down cash. The examiner should review both the business and personal canceled checks from the taxpayer's bank accounts and consider the following questions: Are there checks written to grocery stores for food or to other stores for clothing or other everyday expenses? Are there only checks written for monthly bills such as utilities or loan payments? Are there checks written to cash or ATM withdrawals to verify the taxpayers' means of obtaining pocket cash? Is this consistent with the taxpayer's testimony?

Remember, the taxpayer may disclose all cash business expenses to obtain deductions but personal expenses paid in cash may not be as evident and may require investigation. It is also possible that the taxpayer is paying for personal living expense items by credit card. Therefore, it is also necessary to review credit card statements. The goal is to establish the method of payment the taxpayer is using.

It is also essential to comment on the adequacy of the taxpayer's income records. Are there contemporaneous records of income? The examiner should be aware of evidence to the contrary.

The law states that where there are no or inadequate records of income, the IRS has the authority to reconstruct income by any reasonable means. Water consumption analysis is the means by which laundromat income is reconstructed; however, it is necessary to establish that the records of income are inadequate. To this end, the examiner should photocopy records of laundromat income during the initial appointment.

WATER CONSUMPTION ANALYSIS

Examiners are urged to study the logic and suppositions of the water method. Taxpayers will have many questions on the calculations. A well-prepared response to the taxpayer's questions will lead to a better examination.

As explained earlier, the water consumption analysis is a common sense approach to estimate the revenue of a laundromat. Because each washing machine uses water at known rates, the number of loads washed and dried by the laundromat are determined based on the amount of water used. This enables laundromat income to be reconstructed. The following explains the steps in the reconstruction.

Data Needed for a Consumption Analysis

See Exhibit 3.

1. Workpapers 1 and 2 summarize washer and dryer characteristics. If the taxpayer is unsure or uncooperative, Exhibit 5 is a list of capacities developed from information received from manufacturers and expert field testing.
2. Workpaper 3 calculates waste water for the laundromat.
3. Workpaper 4 records water consumption and supplemental gas and electricity information. Exhibit 6 is an example of a water consumption analysis providing a more detailed explanation of the calculations.

Determining Standards

Standards are a combination of manufacturer's specifications, industry standards and estimates, and testing done in the research and development district. Exhibit 5 gives the standard gallons used for all major washers used in the United States. The field-test specifications in Section C of Exhibit 5 are considered the most reliable (as explained later). Use these unless the taxpayer offers better documented information. Exhibit 7 is a list of manufacturers.

Water Method - Wash Income

The standard water usage per load varies depending on, among other things, the model, manufacturer, the age of the model, the cycle setting, whether the washer has a water level adjustor and whether the adjustor is used.

When the laundromat owner purchases the washer, information is provided as to the standard water usage per load. If the taxpayer does not have the information, use the field test amounts established in Exhibit 5. Alternatively, the distributor or manufacturer can be contacted for further information.

Identifying the washer model can be confusing. For example, Speed Queen has two 25-pound capacity side loaders. One model is manufactured domestically by Speed Queen under the Speed Queen label; the other (the Excel Line) is purchased from a Belgian manufacturer and also sold under the Speed Queen label. The washer manufactured domestically is called "Super2" by the manufacturer and distributor. Laundromat owners call it "Super 20." It is the most popular 25-pound Speed Queen washer.

Prewash is a built-in part of the cycle. Some models have a programmable cycle; others do not. For example, the owner can program a prewash on an 18- but NOT a 25-pound Speed Queen.

Washer names also can be confusing. For example, Wascomats washers are called Giants, Seniors, Super Juniors and Juniors. The standard Wascomat holds 12 pounds. A junior holds one and one-half times the top loader capacity. A double holds twice the clothes (25 pounds); however, Wascomat has an 18-pound washer labeled as a double.

Some washers have a water level adjustor. If employed, it would decrease the gallons per load. This could be an issue. Therefore, it is part of the questionnaire.

Not all washers equipped for the same clothes capacity use the same amount of water. For example, a Speed Queen side loader, equipped for 25 pounds of clothes, uses 45 gallons of water. On the other hand, a Wascomat side loader, equipped for 25 pounds of clothes, uses 50 gallons.

IMPORTANT NOTES: In practical application, consumers do not generally load top-load washers to absolute maximum capacity. This means that the top-load washers could be using more water than the manufacturer's specifications would indicate. Therefore, if the examiner were to rely on the manufacturer's water consumption figures, the income estimate for the top-load washers may be overstated. Secondly, manufacturers of front-load washers generally rate their per cycle water consumption with the basket empty. When dry clothes are placed in the wash basket and the washer is started, the water is absorbed into the clothes. This takes the weight off the fill-control pressure switch and additional water is allowed to enter the wash basket. Therefore, if the examiner were to rely on the manufacturer's water consumption figures, the income estimate for the front-load washers could be overstated also.

Therefore, a conservative approach is encouraged by using the expert field-test results shown in Exhibit 5. The gallons per standard cycle shown include any potential variance from the manufacturer's specifications that occur due to the reasons noted above. The field-test water amounts yield a more conservative outcome which reduces potential errors.

If the taxpayer disagrees with these estimates, it is up to the taxpayer to provide better information. The consumption analysis is an estimate of income and any additional factor that could affect the consumption of water should be taken into consideration.

Water Method - Dry Income

Because the dry income is determined using the number of loads obtained from the wash income analysis, be aware that the washing machine standards have an affect on the dry income calculation. Any change in a washing machine standard will alter the number of loads calculated thereby changing the dryer income computation as well.

Calculation of Water Waste and Taxpayer Statements Which Could Affect the Consumption Analysis

Water waste is the amount of water which is not used in the production of income. It is beneficial to determine the amount of water waste from the taxpayer during the initial interview. Exhibit 3, Workpaper 3, can be used as a guide when interviewing the taxpayer regarding various types of water waste.

It is not essential, however, to pinpoint a specific number of gallons as waste water. It is essential that the examiner has an understanding and a feel for the concept of a large volume of water. For example, if the taxpayer is claiming waste water of 500,000 gallons, the examiner must understand that 500,000 gallons is an enormous amount of water (A typical swimming pool holds approxi- mately 18,000 gallons). It would be very difficult for the taxpayer to use such an amount in one year for general cleaning, public sinks and restrooms, and even leaks.

Based upon experience of previous examinations, an acceptable range of water waste is 0-7 percent of the total gallons used per year. An amount of 3-5 percent would be an average amount with 7 percent being on the high side in the case of unusual circumstances. Moreover, waste water generally should not be more than 7 percent. If the taxpayer is claiming substantially more, he or she should be asked to provide a reasonable explanation(s) and documentation to support his or her assertion.

A good technique to verify water waste due to numerous repairs and large floods is to look for the corresponding repair invoice in repairs expense deducted. Many laundromat owners do their own repairs but there should still be expenses for various parts. Secondly, a large flood should be reflected in the water usage for that particular month.

The actual water meter itself is also important in the calculation of waste water. The examiner should verify that the laundromat has its own water meter. A large discrepancy may initially exist only to find later that the laundromat's water meter is hooked to other businesses or homes (sometimes even without the taxpayer's knowledge). That is, it is a common meter and measures water usage for more than just the laundromat. For example, if the laundromat is attached to a restaurant, apartment, etc., it would be prudent for the examiner to investigate further. The examiner may want to inquire at the water company about the number of addresses serviced by that one meter.

In the instance of a shared water meter, the water consumption analysis may be far less reliable because water waste cannot accurately be measured. The examiner may wish to fall back on traditional indirect method audit techniques.

CUSTOMER USE PERCENTAGES AND VISITING THE LAUNDROMAT

Customer Use Percentages

One of the variables in the water consumption methodology is the customer use percentage of each machine. The computation of income varies depending upon the percentages because these percentages allocate the total gallons to each machine. Because each type of machine has a different income amount per load, a change in the allocation will change the total income computed.

It is reasonable to allocate the customer use percentages based on the percentage allocation of machines in the laundromat. For example, if the taxpayer has seven top loaders, two double-load front loaders, and one triple-load front loader, the customer use percentages would be 70 percent, 20 percent, and 10 percent, respectively.

The taxpayer may assert that the percentages are slightly different for a specified reason. If the explanation is reasonable, the percentages asserted should be accepted. However, if the taxpayer claims that customers only use the less expensive small machines or hardly ever use the large machines (which yield more income), the examiner should question the validity of the statement. Such a statement will obviously have an impact on the income computation.

If a reasonable allocation cannot be agreed upon, the examiner can suggest an observation test to the taxpayer. The patrons of the laundromat can be randomly observed on a Friday afternoon (usually a busy time) to test customer usage of each machine.

It is also important to remember any differences that exist between the current year and the year(s) under audit. If the taxpayer now has new equipment, question him or her about the old equipment and base your calculations using data for the machines that were in the laundromat during the year(s) under exam.

Visiting the Laundromat

Testing a laundromat involves, among other things, keeping tallies. By observing customer behavior for several hours, the examiner can document the patterns of customer use of each washing machine. This information can then be provided to the taxpayer and assist in resolving conflicts on the issue of customer use percentages.

In addition, the observation allows the examiner to observe the number of quarters patrons feed into the dryers to dry different washer loads. Secondly, if the taxpayer is claiming that some customers use the washers but do not use the dryers, the examiner can monitor this also. The information obtained can then be utilized in the computation of dry income.

Other aspects of the laundromat can also be observed to verify taxpayer responses regarding profitability and to verify other issues. For example:

1. Does an attendant drop in to clean up the laundromat? Did the taxpayer mention that he or she employs an attendant? Do employment tax returns include the attendant?
2. Is the bathroom unlocked for public use? Is a public sink available? Is the laundromat sparkling clean or have the floors not been scrubbed this week? Does this coincide with the taxpayer's statements regarding water waste?
3. What type and how many bill changers does the laundromat have? Are these newer models that accept larger bill denominations and have larger capacities? This information can be useful in the determination whether the taxpayer leads a cash existence.
4. Are there pay telephones, soap, video games, soda and snack sales? These items should be included in ancillary income in the reconstruction.

TAXPAYER ARGUMENTS CONCERNING THE ISSUE OF DRYER INCOME

Illustrations follow.

<p>Example 1</p> <p><i>Taxpayer</i></p> <p>Two washer loads are dumped into one dryer: How does your formula take that into account?</p>	<p><i>Examiner Response</i></p> <p>If two loads were put into one dryer it would take about twice as long to dry. The resulting estimate of income would be the same either way.</p>
<p>Example 2</p> <p><i>Taxpayer</i></p> <p>There is no such thing as a typical dryer load. What if the load is all T-shirts and underwear? It does not take as much time/energy to dry a load of T-shirts and underwear as it takes to dry a load of blue jeans. Therefore, dryer income cannot be reconstructed.</p>	<p><i>Examiner Response</i></p> <p>Patrons of your laundromat do not exclusively dry one type of clothing such as T-shirts and under-wear. One load of clothes might be all T-shirts and underwear, but the next might be all blue jeans. It should average out</p>
<p>Example 3</p> <p><i>Taxpayer</i></p> <p>At least 25 percent of my customers exit with wet clothes. Is this taken into account in the calculations?</p>	<p><i>Examiner Response</i></p> <p>In our experience, virtually all clothes washed in a laundromat are dried there. However, we can do a random observation of your laundromat activity to establish the facts.</p>

WHAT TO DO IF THE TAXPAYER WILL NOT COOPERATE

Taxpayer cooperation is preferable but not essential. If the taxpayer chooses not to cooperate, do your best to reconstruct income without taxpayer's input. Use current wash/dry prices. Use customer percentages according to the equipment in the laundromat today. For example, if there are five top loaders and five 30-pound side loaders, allocate customer use at 50 percent of the top loaders and 50 percent to 30-pound side loaders.

It may be necessary to issue a summons for water records, bank statements, taxpayer records, and taxpayer responses. Be sure to comply with notice requirements for summonses and third party contact. Proceed with the audit and income reconstruction based on the information obtained. Allow a reasonable amount for waste water.

Mail the taxpayer the reconstruction. Ask for taxpayer's feedback. If the taxpayer refuses to provide further information, process the case based on the best available information.

CASE DEVELOPMENT AND CASE CLOSING CHECKLIST

In addition to the water consumption analysis, the examiner should also use conventional indirect methods where the necessary information is available.

A Source and Application of Funds analysis is particularly useful when the taxpayer operates a cash business. The examiner should ask the taxpayer the usual questions relating to personal living expenses and acquisitions of large personal assets. The examiner should also be certain to establish beginning and ending cash hoard information. These questions should be asked after determining a clear indication of unreported income exists.

A bank deposit analysis can also be another useful indirect method if the taxpayer states that 100 percent of gross receipts are deposited. The bank statements should be analyzed to determine if deposits and gross receipts coincide or if deposits are rounded amounts such as to the nearest \$10.

If the case goes forward unagreed, be sure to include the following in the case file to support your position:

- Copies of the taxpayer's actual income records and bank statements
- Copies of the actual water bills (not just notes)
- Good, clear notes on taxpayer statements and taxpayer responses to specific questions
- Verification that the equipment used in the analysis was in the laundromat in the year under audit

- Clear notes of a visit to the laundromat to verify the accuracy of taxpayer statements and to perform testing as discussed in the section “Customer Use Percentages and Visiting the Laundromat.”

PRIOR LITIGATION

In June 1995, the first Laundromat MSSP case was litigated in the United States Tax Court. Unreported income was determined solely through the use of a water consumption analysis. An example of this type of analysis is set forth in Exhibit 6. This was the first time this unique method of proof was presented to the Tax Court. At the conclusion of the trial, the Court issued a bench opinion. In the opinion, the judge upheld the Commissioner's determination on both the tax deficiencies and penalties asserted in the notice of deficiency. The Court concluded that the use of water consumption analysis "was reasonable in light of the surrounding facts and circumstances." While this bench opinion cannot be cited as precedent in future Tax Court cases, it is still a significant victory for the Service.

Sample

Information Document Request

GENERAL INFORMATION

1. A copy of prior and subsequent year tax returns, that is returns for 19__ and 19__.
2. A copy of related returns. Related returns are returns of companies in which you are an investor, partner, major stockholder or officer.
3. A copy of payroll tax returns (Forms 941, Form 940, Forms W-4 and W-2) for the year(s) under audit.
4. A copy of Forms 1099 issued for the year(s) under audit.
5. The workpapers and schedules used in preparing the tax returns(s) under examination.
6. Books and records pertaining to your income, expenses and deductions for the year(s) under audit.
7. Provide statements for business and personal bank accounts, brokerage and money market accounts for the period December 19__ through January 19__.

Bank information should cover the month immediately prior and subsequent to, as well as the year(s) under audit.

<i>Items #8 - #12 should be requested only after determining a reasonable indication of unreported income exists.</i>

8. Documents concerning loans and repayments, if they occurred in the year(s) under examination.
9. Information on nontaxable income (for example, gifts, interest on municipal bonds, etc.).
10. Documents concerning the purchase and sale or exchange of real estate and personal property during the year(s) under examination.
11. Documentation concerning business and capital expenditures for the year(s) under examination.
12. Water, electricity and gas bills for the periods December 19__ through January 19__ for the year(s) under examination. The utility bills should cover the month immediately prior and subsequent to, as well as the year(s) under audit.

OTHER SERVICES AND PRODUCTS SOLD AT THE LAUNDROMAT

During the year(s) under examination, were there other services and products sold at your laundromat? Please indicate below and provide purchase invoices and price lists.

	Yes/No	Prices	Percentage of Laundromat Gross Receipts
1. Soap and Laundry Supplies	_____	_____	_____
2. Soft Drinks	_____	_____	_____
3. Snacks	_____	_____	_____
4. Wash/Fold Service	_____	_____	_____
5. Dry Cleaning	_____	_____	_____
6. Pinball/Video Games	_____	_____	_____
7. Pay Telephone	_____	_____	_____
8. Other Sales	_____	_____	_____

Sample -Laundromat Utility Questionnaire

Please provide written answers to the questions shown below. Except where noted, your answers should pertain to the year(s) under examination. If you own more than one laundromat, SEPARATELY complete the questionnaire for each that you own. It is essential that the person who knows the most about the laundromat answer the questionnaire. It would be beneficial for that person to meet with the examiner to answer any questions that might arise.

CASH FLOW

Please provide cash flow information about the year(s) under audit.

1. How much cash did you and your family have on hand (out of the bank), at the beginning and conclusion of the year(s) under audit? Cash out of the bank includes cash in your home, in safes, and in your laundromat (coins included).

<i>This question would be asked after determining that a reasonable indication of unreported income exists.</i>

December 31, 19__

December 31, 19__

December 31, 19__

December 31, 19__

2. How many change machines did you have?
3. What bill denominations were accepted by the change machines?
4. Did the attendant make change?
5. Describe the process by which laundromat cash was collected and receipts were recorded.
 - a. Who collected it?
 - b. How often?
 - c. Who counted the cash? Who recorded it?
 - d. Where was it counted?
 - e. Where was the count recorded?
 - f. How often was the count recorded?
 - g. Do you have the original records of income?

6. Into which bank account were each laundromat's gross receipts deposited?
7. What percent of laundromat gross receipts did you deposit in the bank?
8. Please provide a list of business expenses paid by cash for the year(s) under audit.

RECORDKEEPING

Please describe the process by which gross receipts were recorded.

1. Who recorded the receipts?
2. How and what was recorded to determine gross receipts?
3. How, when, and where were receipts recorded?
4. Do you still have the original record of gross receipts?

PERSONAL EXPENDITURES

These questions should not be asked unless there is a reasonable indication that unreported income exists and the taxpayer's books and records are inadequate.

1. Please describe how you and your family pay for the following expenses. Provide canceled checks and credit card statements for the year(s) under examination.

	Cash	Check	Account?	Which Card	Credit Card?	Which
Groceries	_____	_____	_____	_____	_____	_____
Clothing	_____	_____	_____	_____	_____	_____
Gasoline	_____	_____	_____	_____	_____	_____
Restaurants/ Entertainment	_____	_____	_____	_____	_____	_____

2. Do you make large expenditures with cash? For example, have you purchased an automobile, laundromat equipment, home appliances or furniture using cash, in whole or in part?

3. How much cash a week did you give family members in the year(s) under examination?
4. Do you use cash generated by the business for personal expenses or pocket cash?
5. What is the source of cash for you and your family's personal living expenses? Do you use the automatic teller machine or write checks to cash?
6. Do you or your family receive cash from family or friends? Do you have another source of cash?

THE LAUNDROMAT

1. What were the specific makes and models of the washing machines used by each laundromat for each year? What was the price per cycle for each?
 - a. If prices changed during the year under audit, specify when the prices changed, and the new prices per load charged for using the washers and dryers.
 - b. For each washing machine model, per the manufacturer's specifications, what was the standard amount of water used by each?
 - c. Did the washers have a water level adjustor? Did you adjust it? If yes, to what number of gallons?
2. What was the per cycle dry time for the dryers in use at each laundromat for the year(s) under audit?
 - a. What were the specific makes and models of the dryers used at the laundromat?
 - b. What percent of customers dried their clothes at the laundromat?
3. What was the typical cost to dry each type of washing machine load? For example, how many quarters were needed to dry a typical top loader load?
4. What percentage of patrons using each model of washing machine dumped two wash loads into one dryer?
5. In a typical week, what was the approximate number of times the washing machines and dryers were repaired?
6. Estimate what percentage of washing machine customers used each different model of washing machine in each laundromat. For example, 75 percent of the laundromat's customers used the top loaders, and 25 percent used the triple loaders.

Exhibit 2 (4 of 4)

7. In a typical day, how much water was wasted in each laundromat? (Water waste is, for example, water used to scrub floors and flush toilets.)
8. Are the toilets and sinks currently open to the public? Were they in the year(s) under audit?
9. Were there any floods or water leaks during the year(s) under audit? Specify when and estimate how much water was wasted during each incident.
10. Were the laundromats used by the family for personal clothes?
11. Did you use your laundromat utilities for other purposes? (For example did you wash cars and water gardens, etc., at the laundromat?)
12. Did the loads coming from a larger model of washer require two dryer loads to dry? If so, how many quarters were fed into each of the two dryers?
13. Did the laundromat have its own water meter? Was there anything else on the water line? (For example, an apartment or a store?)
14. Were there any problems with the water line? Describe when and what they were.
15. What are the differences between the operation and activity of the laundromat today versus in the year(s) under audit? For example:
 - a. Has the dry cycle been reduced?
 - b. Are the toilets now locked up?
 - c. Is there no longer a sink available to the public?
16. What kind of problems have you had with theft?
17. Was there a full-time attendant at the laundromat in the year(s) under audit? Is that person available to speak with?
18. How many hours a day and how many weeks a year was the laundromat open for business during the year(s) under audit? Currently?
19. In what city or neighborhood was the laundromat located? Describe the weather in the neighborhood during each of the four seasons.

Washer Configuration

Workpaper 1

Taxpayer _____	Laundromat Location _____
Year _____	Examiner _____
Form _____	Date _____

Washer Models	Model 1	Model 2	Model 3	Model 4
Washer Model Names	_____	_____	_____	_____
Dry Clothing Capacity (lbs)	_____	_____	_____	_____
Standard Gallons Per Load (A)	_____	_____	_____	_____
Actual Number Machines of the Different Models; Total # of Washers _____	_____	_____	_____	_____
Customer Use Percentages Total Equals 100% (B)	_____	_____	_____	_____
Wash Income Per Load	_____	_____	_____	_____
Water Level Adjustor Employed?	_____	_____	_____	_____
Is there a Programmable Cycle?	_____	_____	_____	_____
Estimate of the Dry Time Per Load	_____	_____	_____	_____
Number of Times Each Week Each Machine Model Is Repaired	_____	_____	_____	_____

(A) Distributors often give inaccurate information concerning standard gallons per load. Unless you have more accurate information pertaining to a particular machine, standard gallons per load from the expert field-tests will be used. (See Exhibit 5, Part C.)

(B) Customer use percentages are the percentages of customers who use each different washer model. Generally speaking, the washer models found in a laundromat are dictated by customer demand. The taxpayer should have a general idea of which machines are used most frequently, etc.

Review the customer use percentages provided to see if they are realistic. If, for example, the taxpayer states that 80 percent of his or her customers use top loaders, when 20 percent of the machines are top loaders, then percentages should be revised.

If the taxpayer does not cooperate in giving customer use percentages, use the percentages based on the actual number of the different washer models in the laundromat.

When in doubt, a random sample of customer washer activity would establish customer use percentages.

Dryer Configuration

Workpaper 2

Taxpayer _____
 Year _____
 Form _____

Laundromat Location _____
 Examiner _____
 Date _____

Dryer Manufacturer and Model	# of Dryer Units	# of Dryer Chambers Per Model	Dryer Percents (A)	Minutes Model Year	Dryer Per Dry Cycle (B)	Capacity (in lbs.)
_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____

Note: Dryers are typically 30 pound capacities, and are assumed to be so unless otherwise noted.

-
- (A) Dryer percent refers to the actual number of different dryer models at the laundromat. For example, if there were 10 American Dryer stack dryers and 10 Huebsch single dryers, the percentage would be 50/50. If there were all American Dryer stack dryers, the dryer percentage would be 100 percent.
 - (B) Dry cycles are usually 10 minutes. However, they can range from 7 to 15 minutes. Verify that the duration of the cycle is for the year(s) under audit for the dryers in question. A quarter (\$.25) is usually the price of the dry cycle.

Calculation of Water Waste

Workpaper 3

Taxpayer _____
 Year _____ Form _____

Examiner _____
 Date _____

Laundromat #	1	2	3	4	5
Locations	_____	_____	_____	_____	_____

Possibilities (Daily Amounts in Gallons):

1. Toilet Flushes	_____	_____	_____	_____	_____
2. Public Sink	_____	_____	_____	_____	_____
3. Cleaning (Machines, Floor, etc.)	_____	_____	_____	_____	_____
4. Machine Repairs When Water is Required	_____	_____	_____	_____	_____
5. Free Washes	_____	_____	_____	_____	_____
6. Other *	_____	_____	_____	_____	_____
7. DAILY WASTE TOTAL (Total of 1-6)	_____	_____	_____	_____	_____
8. X Number of Days Open A Year	_____	_____	_____	_____	_____
9. =Daily Waste Total (Annualized)	_____	_____	_____	_____	_____
10. Floods, Leaks (Annual Estimate)	_____	_____	_____	_____	_____
11. = GALLONS WASTED FOR YEAR (Line 9 + Line 10)	_____	_____	_____	_____	_____
12. Divided by 748 (A)	_____	_____	_____	_____	_____
13. = 100 CUBIC FEET WASTED FOR YEAR	_____	_____	_____	_____	_____
14. + Use by Attached Rental Unit	_____	_____	_____	_____	_____
15. = TOTAL WASTE IN 100 CUBIC FEET	_____	_____	_____	_____	_____

*Other waste possibilities encountered include: showers, hosing down parking lots, stolen water, personal use

(A) Water bills are typically stated in hundred cubic feet. There are 748 gallons in a hundred cubic feet. Waste water should be stated in hundred cubic feet.

Water, Electricity and Gas Consumption

Workpaper 4

Taxpayer _____ Laundromat Location _____
 Year _____ Examiner _____
 Form _____ Date _____

Month	Water Consumed 100 Cubic Feet (A)	Electricity* Consumed (kwh) (B)	Gas* Consumed (Therms) (C)
January	_____	_____	_____
February	_____	_____	_____
March	_____	_____	_____
April	_____	_____	_____
May	_____	_____	_____
June	_____	_____	_____
July	_____	_____	_____
August	_____	_____	_____
September	_____	_____	_____
October	_____	_____	_____
November	_____	_____	_____
December	_____	_____	_____
	_____	_____	_____
	=====	=====	=====

* Although not used in the calculation, electricity and gas usage information can be valuable in establishing patterns. One excellent suggestion for determining the adequacy of the books would be to compare monthly income patterns to actual water, electricity, and gas usage fluctuations. It would be logical to expect income to decline (or rise) when utility usage decreases (or increases). If there is no correlation, all receipts are possibly not being reported.

- (A) Usually water consumption on water bills is stated in hundred cubic feet. Sometimes it might be stated in gallons. There are 748 gallons in a hundred cubic feet. To convert from gallons to hundred cubic feet, divide by 748.
- (B) Electricity bills state electricity consumption in kilowatts hours (Kwh).
- (C) Gas bills state gas consumption in therms. Some might state consumption in BTUs or hundred cubic feet. Gas consumption must be stated in therms. There are 100,000 BTUs in a therm and 100 cubic feet equals one therm.

Explanation of Water Consumption Analysis

1. Hundred Cubic Feet Consumed (for the year) is according to the water bill. It is multiplied by 748 to convert it to Gallons Consumed For the Year.
2. Waste Water (for the year) is calculated and netted from Gallons Consumed For the Year to arrive at Gallons Used to Produce Income.
3. Gallons Used to Produce Income are distributed pro rata to wash models based on two rates: Standard Gallons Per Load and Washer Customer Percents.
4. Gallons Used to Produce Income, after apportionment to each wash model, are divided by standard gallons per load to determine the Number of Wash Loads (per wash model).
5. The Number of Loads (per wash model) is multiplied by Wash Revenue Per Load (per wash model) to determine Wash Revenue (per wash model). Wash Revenue (per wash model) for all models is totaled to arrive at (total) Wash Revenue.
6. Dryer Loads (per dryer model) are multiplied by Dry Revenue Per Load (per dryer model) to arrive at Dryer Revenue (per dryer model). Dryer Revenue (per model) is added to arrive at (total) Dryer Revenue.
7. Incidental Income is calculated on the basis of markup.
8. Wash/Dry Revenue is added to Incidental Income to arrive at Reconstructed Laundromat Income Per Water Consumption Analysis.

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Exhibit 5 (1 of 3)

Washing Machine Standards

A. Washer Generics

<u>Clothing Capacity in lbs.</u>	<u>Gallons Per Load</u>
12	35
14	34
17	40
18	38
20	56
25	47
30	66
35	67
40	67
50	94

B. Washer Specifics per Manufacturer

<u>Manufacturer</u>	<u>Clothing Capacity in lbs.</u>	<u>Gallons Per Load</u>	
Dexter	18	42	
	20	56	
	25	50	
	40	67	
General Electric	12	39	
IPSO	18	34	
	25	40	
	35	67	
Maytag	14	34	
	17	40	
	18	36	
	35	80	
	50	108	
Pelerin Milnor	35	48	
	50	63	
Primus (Primus is sometimes sold under the other labels)	18	34	
	25	40	
	35	65	
	50	90	
Speed Queen	12	32	
	18	35	
	25	47	
	30	66	
	40	85	
	50	110	
Unimac (Unimac also sells under Maytag and other labels)	18	46	
	25	60	
	35	75	
	50	99	
Wascomat	18	36	
	30	60	

C. Washer Specifics - Expert Field-test Results

<u>Manufacturer</u>	<u>Total Water Capacity (lbs.)</u>	<u>Average Clothing Usage (Gallons)</u>
Wascomat	18-Pound Capacity	34
	30-Pound Capacity	58
	35-Pound Capacity	78
	50-Pound Capacity	101
Maytag	Standard Tub (14-Pound)	34
	Large Tub (18-Pound)	41
Milnor	35-Pound	66
Speed Queen	Top Load Perforated Tub	34.5
	Super-Load II 25# Front-Load	52
General Electric	Top Load	39
General Electric *	Top Load	33.5
IPSO	18# Front-Load	34

*Water Saver Model

Consumption Analysis Example

**Water Consumption Analysis
Taxpayer A/9312**

Water Consumed Per Water Bills

Month	Hundred Cubic Feet Consumed
January	550
February	500
March	525
April	500
May	450
June	400
July	500
August	500
September	550
October	500
November	525
December	550
Total Water Consumed by Laundromat	6,050

**Calculation of Waste Water and
Gallons Used to Produce Washing Machine Income**

Hundred Cubic Feet Consumed	6,050
Convert to Gallons	x <u>748</u>
Gallons Used	4,525,400
Less Waste Water	<u>226,000</u>
Gallons of Water Used to Produce Income	4,299,400 =====

**Water Consumption Analysis
Taxpayer A/9312**

**Calculation of Washing Machine Income
Percent of Water Used by Each Washing Machine**

<u>Washing Machine</u>	<u>Percent of Customers Use of Each Machine</u>		<u>Gallons Per Load</u>	<u>Percent of Water Use</u>
Washing Machine #1	0.75	x	36 = 27.00/36.90 =	0.7317
Washing Machine #2	0.15	x	38 = 5.70/36.90 =	0.1545
Washing Machine #3	0.10	x	42 = 4.20/36.90 =	0.1138
	<hr/>		<hr/>	
	100%		36.90	

Number of Loads Washed

<u>Washing Machine</u>	<u>Percent of Water Use</u>		<u>Total Gallons</u>	<u>Gallons of Water</u>	<u>Gallons Per Load</u>	<u>Loads Washed</u>
Washing Machine #1	73.17	x	4,299,400	= 3,145,871 /	36	87,385
Washing Machine #2	15.45	x	4,299,400	= 664,257 /	38	17,480
Washing Machine #3	11.38	x	4,299,400	= 489,272 /	42	11,649
	<hr/>		<hr/>	<hr/>		
	100%			4,299,400		116,514

Calculation of Washing Machine Income

<u>Washing Machine</u>	<u>Loads Wash</u>	<u>Revenue Per Load</u>	<u>Income</u>
Washing Machine #1	87,385	1.00	\$ 87,385
Washing Machine #2	17,480	1.50	\$ 26,220
Washing Machine #3	11,649	2.25	\$ 26,210
 Total Washing Machine Income			 \$139,815

**Water Consumption Analysis
Taxpayer A/9312**

Calculation of Dryer Income

<u>Washing Machine</u>	<u>Loads Dried</u>		<u>Cost Per Load to Dry</u>		<u>Income</u>
Washing Machine #1	87,385	x	0.50	=	\$43,692
Washing Machine #2	17,480	x	0.50	=	\$ 8,740
Washing Machine #3	11,649	x	0.75	=	<u>\$ 8,737</u>
Total Dryer Income					\$61,169

Summary of Laundromat Income

Washing Income	\$ 139,815	
Dry Income	\$ 61,169	
Candy Sales	\$ 3,000	
Soda Sales	\$ 3,100	
Soap Sales	\$ 800	
Wash/Fold Services Sales	\$ 0	
Other Sales	\$ 200	
Total Laundromat Income Per Water Consumption Analysis		\$ 208,084
Laundromat Income Per Return		<u>\$ 160,000</u>
Adjustment to Income	\$ 48,084	=====

Major Manufacturers of Laundromat Equipment.

American Dryer Corporation
88 Currant Road
Fall River, Massachusetts 02720-4781
Telephone (508) 678-9000
www.amdry.com

Cissell Manufacturing Company
831 South First Street
P.O. Box 32270
Louisville, Kentucky 402032-2270
Telephone (502) 587-1292
www.cissellmfg.com

The Dexter Company
Post Office Box 210
Fairfield, Iowa 54556
Telephone (515) 472-5131
www.dxtreco.com

General Electric Company
Louisville, Kentucky 40225
Telephone (800) 327-7606
www.ge.com

Huebsch
Alliance Laundry Systems LLC
Shepard Street
Ripon, Wisconsin 54971-0990
Telephone (920) 748-3121
www.huebschonline.com

IPSO USA
99 Aberdeen Loop
Panama City, Florida 32405
Telephone (850) 271-5959
www.ipsousa.com

Maytag Corporation
403 W. 4th Street, N.
Newton, Iowa 50208
Telephone (515) 792-7000
www.maytag.com

Norge (now defunct)
(part of the Maytag conglomerate)
410 East Lyerla Drive
Herrin, Illinois 62948
Telephone (618) 988-8431

Pellerin Milnor Corporation
Post Office Box 400
Kenner, Louisiana 70063-0400
Telephone (504) 467-9591
www.milnor.com

Primus
28 Mitchell Road
Ipswich, Massachusetts 01938
Telephone (978) 356-8860

Speed Queen Company
Alliance Laundry Systems LLC
Shepard Street
Ripon, Wisconsin 54971-0990
Telephone (920) 748-3121
www.speedqueen.com

Unimac Company, Inc.
Alliance Laundry Systems LLC
Shepard Street
Ripon, Wisconsin 54971-0990
Telephone (920) 748-3121
www.uniwash.com

Wascomat of America
461 Doughty Boulevard
Inwood, New York 11096
Telephone (516) 371-4400
www.wascomat.com

Whirlpool Company
2000 N. M-63
Benton Harbor, Michigan 49022
Telephone (800) 253-1301
www.whirlpoolcorp.com

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3. Internal Revenue Code section 446(b).
4. Marten, *Law of Federal Taxation*, Callaghan & Company, Sections 55.16 through 55.51 and 55B.03 through 55B.47.
5. *Prentice-Hall Tax Service*, Published by Prentice-Hall, Inc., 1990, Sections 4464.1 through 4465.88.
6. *Tax Management Portfolio*, Tax Management, Inc., A Subsidiary of the Bureau of National Affairs, Inc., 1990, 441 2d, Sections A-21 through A-26..
7. Treasury Regulation section 1.446-1(b).