

What the IRS Looks For When It Audits a Bar or Restaurant

Key audit triggers from the IRS Retail Industry & Cash Intensive Businesses Audit Technique Guides

Bars and restaurants are classified by the IRS as **cash intensive businesses** — one of its highest-priority audit categories. Examiners preparing to audit a bar or restaurant work from two published playbooks: the **Retail Industry Audit Technique Guide** (Restaurants & Bars chapter) and the **Cash Intensive Businesses ATG**. Here's what those guides tell agents to look for — and what that means for how you run your books.

1. They Assume Cash Is Being Skimmed — and Reconstruct Your Income

- **Bank deposits alone won't clear you.** The guides instruct agents that a bank deposit analysis "should generally be supplemented with another indirect method" for bars and restaurants, because cash may never hit the bank.
- **Seat-turnover math:** $\text{seats} \times \text{daily turns} \times \text{average check} = \text{projected daily sales}$, extended to annual sales and compared against your return.
- **Guest-check counts:** agents can contact your guest-check printer to learn how many checks you bought in a year, then multiply by your average ticket.
- **Pour tests & markup analysis:** liquor purchases are converted to expected drink revenue using standard pour sizes; gross profit ratios are compared to industry norms. Consistently low margins or losses that couldn't sustain the owner are the #1 red flag.

2. Records They Will Demand

- Daily **Z-tapes / POS reports** matched line-by-line to the sales journal — discarding register tapes (as in the *Kikalos* case) lets the IRS pick its own reconstruction method and courts will back it.
- All **bank statements — business and personal** — deposit slips, and cash payout records; sales tax returns reconciled to gross receipts on the return.
- A **tour of the premises** and an owner interview covering cash-on-hand (including safes and cash at home), who counts and deposits receipts, and whether the same person does both.

3. Income Sources Agents Are Told You Might Be Hiding

- Vending, ATM, pool table, jukebox, and amusement machine income; cover charges and door receipts.
- Vendor rebates and allowances (especially those paid by check with no invoice trail), promotional prizes and trips from distributors.
- Off-book liquor purchases — buying retail off the shelf and selling drinks with no invoice or income ever touching the books.
- Owner personal use of food and liquor inventory that never gets backed out of cost of goods sold.

4. Payroll & Tip Exposure

- Employees paid in cash without employment taxes; cash-paid credit card tips that were never added back to the deposit analysis.
- Tip reporting compliance — employers must match FICA on reported tips, and unreported tips are a standing exam issue in every bar/restaurant audit.

RISK FLAG — Where taxes and insurance collide: The same records the IRS reconstructs — POS data, sales journals, payroll — are what your insurer uses to set liquor liability, general liability, and workers' comp premiums. Understated sales create **underinsured exposure**; an audit that restates income upward can also trigger premium audits, retroactive comp adjustments, and coverage disputes. Cash payroll can void workers' comp protection entirely.

GOOD NEWS: Clean books protect you twice. The ATGs tell agents that **strong internal controls mean minimum income probes** — daily POS reconciliation, segregated cash duties, retained Z-tapes, and documented tip reporting shorten audits and keep them limited. Those same disciplines get you accurate insurance ratings, smooth premium audits, and full coverage when you need it. Both IRS guides are public — reviewing them with your CPA is free audit protection.