State Sales Tax Liquor Audits of the Bar and Restaurant Industry: An Overview of State Efforts and Common Issues*

*By Michael Dillon***

Michael Dillon discusses methodologies used by the state to conduct liquor audits of the bar and restaurant industry, and how taxpayers can reduce potential assessments and avoid penalties.

CCH a Wolters Kluwer business

Overview

According to most recent U.S. Census figures, sales, use and gross receipts taxes comprise, on a national average, approximately 30 percent of annual state and local revenues by type of tax.[1] This figure is further supported by the recent findings reported in a study prepared by Ernst and Young's Quantitative Economic and Statistics practice (QUEST) in conjunction with the Council On State Taxation (COST).[2] With sales, use and gross receipts taxes representing such a substantial percentage of state and local tax revenues, states are continuously seeking new methods and new technologies to enforce collection of their taxes on registered in-state taxpayers, as well as unregistered out-of-state taxpayers. The main method used by states to enforce their collection is sales tax audits. Obviously, one of the most difficult factors with which states grapple is the selection of taxpayers—audit a compliant taxpayer and you have just wasted state money and the taxpayer's time.

Numerous states have conducted audits of establishments in the bar, packaged-good and restaurant industries.[3] For example, Maryland is in the midst of an alcohol audit project. According to the state comptroller's office, "The Comptroller's Office persuaded all 74 liquor wholesalers in Maryland to hand over sales records of transactions done with retailers in the state. Auditors compared the wholesale records with the sales their customers reported in tax returns.

Michael Dillon, Esq., is a Senior Manager with SC&H State & Local Tax Consulting in Baltimore, Maryland.

©2006 M. Dillon

Auditing software purchased from ACL Services was used to juxtapose the two sides, revealing underreported sales from some retailers."[4]

"Thanks to cooperation from the alcoholic beverage industry, we can compare product deliveries to liquor stores and what they, in turn, report as sales," Comptroller William Donald Schaefer said in a statement. "As a result, we have found outright fraud in nearly half the cases we've audited, with some businesses grossly underreporting sales taxes. We're constantly on the lookout, so we may be coming to a bar or liquor store near you."[5] From 2002 to 2005, the Comptroller's office has conducted nearly 100 audits under this program, resulting in 51 cases of fraud and 22 cases of gross negligence, generating more than $30 million in tax, interest and penalties. Civil fraud can result in a penalty of up to 100 percent of the tax due, and a waiver of the statute of limitations, which is normally four years.[6] Likewise, states such as California, New Jersey, New York, Ohio and Texas have similar alcohol audit projects.

In California, the state has been conducting sales and use tax audits of bars, restaurants and packaged-goods stores for a number of years under a program so formalized that the state has an audit manual and specific policies and procedures set forth just for audits of the industry.[7] The manual sets forth procedures for establishing drink size, drink prices, product categories and losses, as well as methodologies for computing and testing a weighted average mark-up and the cost of sales, two computations that are often employed in state sales tax audits of the liquor industry when a taxpayer's records appear inaccurate or incomplete.

Furthermore, the California State Board of Equalization has issued "SBE Publication 24 Tax Tips for Liquor Stores," which provides sales and use tax advice to liquor stores. In this publication, the state provides that solid inventory controls are important for several reasons, including that a store operator must be able to account for all merchandise purchased for resale. "If you are audited by a Board representative, he or she will compare your purchases with your sales. If the volume of sales appears low in comparison to the volume of purchases, you will be asked to account for the difference. Sometimes the difference is because of losses of merchandise from robberies, shoplifting, or short deliveries. Good records will help you account for those losses."[8] The state also advises store owners to look for the following types of losses:

- Money pocketed by employees and covered up by not ringing up the sale or ringing it up at a lesser amount
- Merchandise pilfered by employees, clean-up crews or other persons with access to the store
- Short deliveries or pilferage by delivery persons
- Shoplifting by customers[9]

Unless the taxpayer can substantiate through documentation specific amounts of loss (including spillage, shrinkage and pilferage), the state assumes certain percentages by product category (*i.e.*, liquor, wine, bottled beer and draft beer).

> Taxpayers should also keep weekly records of sales and losses due to breakage factors, such as spillage, spoilage and pilferage.

The Florida Department of Revenue maintains a specific Web page for distributing sales and use tax information regarding bars and lounges. The Web site provides methodologies for computing taxes, reference materials, instructions, forms and contact information.[10]

In New York, there are numerous sales tax audit cases involving the bar and restaurant industry.[11] Most of these involve the use of an indirect audit method due to insufficient taxpayer records and substantial underpayment of taxes.

In Ohio, the Department of Taxation works in a collaborative effort with the Ohio Department of Commerce to share tax and revenue information regarding the holders of liquor licenses. "Tax payments from excise taxes on beer, wine, and mixed beverages were approximately $57.7 million in Fiscal Year 2005."[12] As in New York, in Ohio there are numerous cases involving the use of an indirect audit method due to insufficient taxpayer records and substantial underpayment of taxes.

In Texas, the state has issued numerous assessments against liquor license holders, based on the use of an indirect audit method due to insufficient taxpayer records.[13] In addition to sales and use taxes, the state also imposes a mixed beverage gross receipts tax on liquor, wine and beer sales at bars and restaurants. In furtherance of its enforcement efforts with respect to this tax, the state comptroller's office has published the "Texas Mixed Beverage Gross

CCH a Wolters Kluwer business

Receipts Tax Guide," which provides definitions, sample source documentation to be retained by taxpayers, sample tax forms, as well as compliance and auditing procedures.[14]

U.S. Census figures provide that in 2002 there were 14,855 bars, taverns and pubs in the United States that classify themselves under the NAICS code 722410 (Drinking places—Alcoholic beverages).[15] Total annual sales for this industry group in 2002 were $14.5 billion. With so much potential sales tax revenue at stake, numerous states have long sought to ensure that the owners of these establishments and liquor license holders are fully compliant with their recordkeeping and tax remittance obligations. After all, according to these states and industry analysts, the bar and restaurant industry has a significant amount of cash-based transactions, a high percentage of thefts of liquor and embezzlement by employees, as well as spillage and spoilage.[16] Coupled with potentially unsophisticated accounting systems, states have long perceived the bar and restaurant industry as an ideal target for sales tax audits. Furthermore, the liquor industry is a licensed industry, providing two important attributes for state audit and enforcement efforts: (1) states are capable of obtaining distributor sales records to utilize in estimating the gross sales of taxpayers operating bars and restaurants, and (2) states are provided an effective enforcement mechanism in that they may place liens on taxpayers' liquor licenses in order to enforce collection of final assessments.

CCH a Wolters Kluwer business

Technology and Fraud Hypothesis Testing

As previously stated, one of the most difficult factors for states is the selection of taxpayers for audit, even within a specific industry or industry sector. States have recently begun using technology to assist in taxpayer audit selection. Not only has the use of computer software programs enabled state revenue departments to more carefully select which taxpayers to audit; in addition, the use of "fraud hypothesis testing" has enabled states to focus their audit activities on particular industries—industries that have historically presented a compliance challenge to states.[17]

For example, in Maryland, fraud hypothesis testing and software have enabled the state to identify certain bar, restaurant and packaged-good store owners as targets for sales tax audits, based on preliminary analysis of third party data evidencing cases of sales tax fraud.[18]

Fraud hypothesis testing requires that the examiner begin with the null hypothesis that fraud does not exist, and then examine this hypothesis against a set of customized queries to search for those specific red flags or a combination of red flags to test each of the specific fraud hypotheses. By starting with the null hypothesis that liquor establishments do not underreport their sales on their sales and use tax returns, the state can test this hypothesis by obtaining the sales records maintained by distributors.

Distributors are required to maintain these detailed sales records, as they are claiming a resale exemption of these sales to liquor establishments, and they too are licensed. States can obtain distributor sales records by customer, load the data files into a database using software such as Monarch and ACL to read the data files from each distributor and convert the data to an Excel spreadsheet, and compare the total amount of purchases made by each liquor establishment, as reported by the distributors, to the total amount of sales reported on the sales and use tax returns. If the variance is significant, the null hypothesis has been disproved and the state contacts the taxpayer to begin a routine examination of the business records.

Audit Methodologies

Direct or Routine Audit

Once a taxpayer is identified for an audit, states will typically attempt to conduct a complete audit of taxpayer records. This normally involves obtaining all fixed asset invoices and a sample of expensed purchases and sales. Supporting invoices and register receipts are compared to reports for the same periods in an attempt to reconcile taxable sales and purchases to those reported on the sales and use tax return for the same periods.

Given the cash basis on which many liquor establishments operate, detailed reporting and supporting invoices or receipts are sometimes lacking or incomplete. If the business records of the liquor establishment are determined to be incomplete or inaccurate, states are authorized to employ other available means to audit the taxpayer.

Indirect Audit

In the case of the liquor establishments, indirect methods typically involve use of distributor records to compute a mark-up, gross sales and related sales tax, rather than calculating sales tax based on actual sales records. The audit methodologies typically

employed for determining mark-up on purchases and gross sales is similar to one of a number of methodologies employed by the IRS for audit investigations of bars and restaurants.[19] The most commonly employed method is the unit volume method. In this method, the auditor will calculate a mark-up (typically anywhere from 300 to 500 percent, based on the purchase amounts provided by the distributors and applying an appropriate sales factor). Specifically, the auditor will obtain detailed beer, liquor, wine, beverage and food sales from the distributor for a sample period. The auditor will obtain pricing from the establishment owner, and in the absence of available supporting information, may make numerous assumptions regarding the number of drinks that can be poured from a bottle, drink size (*e.g.,* the number of units in a bottle, typically 1.5 ounces for mixed drinks, one unit for a bottled beverage, such as beer, and 6.3 ounces for a glass of wine), spillage (*i.e.,* the amount lost due to overpouring and breakage) and shrinkage (*i.e.,* the amount lost due to theft and fraud). By multiplying detailed distributor sales by drink size and drink price, the auditor can compute a weighted average mark-up for the sample period. Typically making some allowance for shrinkage, the mark-up is then multiplied by distributor sales for the audit period to calculate estimated gross sales for the audit period. The most important factors in the unit volume method are the unit price and the drink size. The mark-up typically involves a number of assumptions that are fraught with potential error. For example, some of the assumptions involve consistency in pricing, drink pour size, glass size, spillage, shrinkage, and consistency of inventory and product mix throughout the entire audit period. Inaccurate assumptions by the auditor or information from the taxpayer can significantly impact the audit results.

For example, in Maryland, if records are inaccurate or incomplete, the Comptroller may compute and assess the tax by use of a survey of the business, a survey of other persons engaged in a similar business, or by other means.[20] This essentially means that the Comptroller will employ an indirect method—a purchase analysis. "A 'purchase analysis' is a means of computing gross sales and taxable sales by marking up inventory and assuring all inventory purchases are sold. Mark-up is the component that is added to cost in order to arrive at a selling price."[21] The indirect method involves obtaining third party data (*i.e.,* distributor sales records) and computing a mark-up upon which to extrapolate the taxpayer's assumed taxable sales and sales tax.

In California, "even though the taxpayer's books and records are comprehensive and in agreement with each other, the Board is not required to accept such evidence as conclusive and may use recognized and standard accounting procedures to establish audited sales. Where the Board establishes a deficiency, the burden of proof is upon the taxpayer to explain any disparity between their books and records and the results of the Board's audit. [*Riley B's, Inc. v State Board of Equalization,* 61 Cal. App. 3d 610 (1976)] The mark-up method may only be used when there is support that the taxpayer's records are inadequate."[22] In the case of *Riley B's, Inc.,* the taxpayer's books and sales records, while complete, were inconsistent with some of the other underlying documents, such as purchase invoices. When purchases were compared to recorded sales, the taxpayer could not explain or document the underreported sales computed by the Board, only offering that the 27 percent error must be due to overpouring and loss. The Board rejected his unsupported explanation, accepting the Board's indirect audit method and noting that the taxpayer cannot "avoid his tax liability simply by maintaining inaccurate but voluminous and consistent records."[23]

In Texas, in the context of a sales tax audit, if the taxpayer's records are inadequate, the auditor is instructed to determine the best information that is available and base the audit report on that information.[24] In fact, in the context of an audit of a liquor store, "[Audit Policy] AP92 instructs all auditors to use 25% as the mark-up for beer if the records of a convenience store are unavailable, inadequate, or unreliable and if the actual mark-up percentage cannot be ascertained by other means."[25] (Note that it is the author's experience that a typical mark-up for a liquor store sales tax audit averages 25 to 40 percent, whereas a typical mark-up for a bar or restaurant sales tax audit averages 300 to 500 percent.) For purposes of the mixed beverage gross receipts tax, "[i]n examining the tax account of each permittee, if the Comptroller finds that the permittee has failed to maintain or make available the records required by any regulation of the Comptroller, the Comptroller may compute and determine the amount of gross receipts tax liability from any available source or records, and estimates of the tax liability may be made by use of any available record for any period for which the permittee has failed to maintain records or file a report with the Comptroller."[26]

CCH a Wolters Kluwer business

Likewise, New York Tax Code §1138 authorizes the Commissioner to compute taxes based on available information, including external indices, where taxpayer returns and records are inadequate. In the context of sales tax audits of food stores, convenience stores, gas stations, bars and restaurants, the most commonly employed methodology involves computation of an assumed mark-up based on purchases.[27]

When compared to actual sales reported per the sales tax returns, a significant variance is rebuttably presumed to be evidence of fraud or gross negligence. In many states, this evidence can have drastic consequences for the taxpayer. For example, the general statute of limitations (the period for which the state can audit a taxpayer and assess for unpaid tax) for sales and use tax returns is three to four years. However, if the variance between tax reported and tax due is significant, fraud or gross negligence is presumed to exist and there is no statute of limitations, or the normal statute is increased to include additional years. [28] Furthermore, in cases of fraud, normal penalty provisions do not apply; instead, the state is typically capable of imposing larger penalties. For example, in Maryland, the Comptroller is able to assess a penalty of up to 100 percent, effectively doubling the assessment.[29] California imposes penalties of up to 35 percent in cases involving fraud or intentional evasion of tax.[30] Similarly, New York Tax Code authorizes a penalty of up to 50 percent in fraud cases.[31]

Bar and restaurant owners should invest in a relatively sophisticated cash register or point-of-sale system, one that can provide detailed sales reports and track complimentary sales and spillage.

Common Issues Associated with Indirect Methods and States' Assumptions

Best Available Records

As stated above, many states provide that an auditor shall conduct an audit using taxpayer records, unless it becomes apparent that those records are inaccurate, inadequate or incomplete, in which case the audit may be conducted using other information (*i.e.,* an indirect audit, based on a purchase analysis and the computation of an assumed mark-up). Auditors will often use the authority granted them to test a taxpayer's compliance by any available information by means of sample data. Sampling based on purchase records is very common in sales tax audits of bars, restaurants and liquor stores, "because these businesses typically have poorly recorded cash transactions. When the auditor suspects that not all sales are reported on the sales tax return or that a proportion of the non-taxable sales is over-stated, the auditor may find adequate records for a few days or perform in-store observations, estimate daily taxable sales based on the records or observations, and project the sales over the entire audit period."[32] "The auditor has more authority in imposing a sampling method when the taxpayer has inadequate records. To overturn the auditor's method, the taxpayer would have to develop some alternative method using available records, or find some way of reconstructing unavailable records."[33]

In such cases where the auditor uses information other than the taxpayer's books and records, a rebuttable presumption is established as to the accuracy of the state's audit assessment, shifting the burden of proof to the taxpayer to rebut the accuracy of the assessment.[34] Given the likelihood of no direct evidence (*i.e.,* cash register tapes, register reports, bank deposits and invoices) to rebut the presumed accuracy of the assessment, taxpayers are at least required to submit other more reliable information that they can assert was the best available information, overcoming the state's reliance on the data it previously utilized. In *Shelly S. Wright, t/a T&M Cut Rate & Lounge v. Comptroller of the Treasury,* the court implies that had the taxpayer provided additional documentation or additional evidence, both the comptroller's office and the court would have seriously considered such evidence, stating:

> But I'll tell you what I did not hear one iota of evidence about, and that is: well, fine, the twenty-eight percent [markup] is an unrealistic number, what is a realistic number? Is it five percent? Is it twelve percent? Is it thirteen and a half percent? In other words, argued very strenuously that the twenty-eight percent doesn't make sense, but nothing was even suggested to the Court, even in argument … as to what the number should be.[35]

CCH a Wolters Kluwer business

Continuing, the court also noted that the comptroller's office stated it "had to use that number because nobody came forward and demonstrated to us what the supposed correct number should be. In other words, they said, we had to react to the information that was available to us." The court had "no doubt … that if satisfactory information was produced to the Comptroller's Office along those lines that they would have adjusted the numbers that they used in coming up with the assessment that they made."

It is therefore incumbent on taxpayers facing an assessment based on an indirect audit method to identify the potential weaknesses in the state's methodology and present evidence in support of what the proper amount of tax should be. For example, in *Food Service Associates, Inc. and Dennis G. Maxwell v. Commissioner,* the State of Massachusetts conducted a sales tax audit of the taxpayer and his restaurants.[36] During the six-year period between filing the returns and date of the audit, many of the taxpayer's guest checks and register tapes were either lost or destroyed. The auditor was required, therefore, to conduct an indirect audit of the taxpayer. To this end, the auditor reviewed bank statements, recording all deposits and backing out transfers between accounts. The auditor then presumed that the remaining balances represented gross sales of the restaurants, including tax. The assumption inherent in this approach is that all deposits represented taxable sales. The auditor claimed that she conducted this audit based on the best information available, but the Massachusetts Appellate Tax Board noted that she never inquired as to whether the restaurants made nontaxable sales. Other shortcomings noted in the auditor's methodology included not allowing for cash on hand at the beginning of the audit period, assuming that all deposits into the bank related to the restaurant activity, and failing to obtain more detailed information about the nature of the taxpayer's business. On this basis, the Board determined that the state had failed to meet its burden of proof in asserting that the appellants had underreported their liabilities, and therefore had failed to prove that the taxpayers filed fraudulent returns. Being that fraud was not involved, the normal three-year statute of limitations was imposed, and the Commissioner had failed to issue the assessments within the three-year statutory period. Accordingly, the entire assessments were abated.

All sales register reports, breakage reports and purchase records should be maintained for at least four years for sales tax audit purposes.

In *Chef Chang's House, Inc. v. Commissioner of Revenue,* the Massachusetts Appellate Tax Board found that deficiency assessments founded on speculative assumptions were not warranted.[37] Based on the review of guest checks and bar sales information from a nine-day sample period, the auditor calculated a liquor mark-up amount. This mark-up amount was then used to project sales figures for the entire audit period. Like the bank deposit analysis at issue in *Foodservice Associates,* Chef Chang's audit assessment was conceptually flawed. In projecting sales, the auditor did not take into account loss of product due to spillage, breakage, theft, loss or free drinks. Instead, the auditor assumed that every ounce of alcohol purchased was sold at retail. In addition, the auditor failed to take into account beginning inventory, "assuming, therefore, that all purchases included in his calculations resulted in retail sales during the period at issue."[38] The Board found that "the audit methods employed were statistically invalid, unreliable and unreasonable. As a result, the Board accorded no weight to the results of the audit."[39]

In *Family Deli of Bellmore, Inc.,* the New York Division of Tax Appeals determined that the Division of Taxation failed to justify the use of an indirect audit method, given that the taxpayer provided the auditor with all of the records requested as well as additional records.[40] In *Constantine and Larcon dba Bach Dor Disco Café v. Commissioner*, the Connecticut Tax Court recognized that the Commissioner has a broad grant of authority to compute and assess sales taxes; however, the court determined that the auditor in the case at hand was not interested in determining actual sales, but rather fitting the operation of the bar into a predetermined mold.[41] The court determined that the Commissioner ignored the taxpayer's records and used only the purchase records to determine the taxpayer's gross receipts, noting that "the facts in the case do not reveal a neglect of the taxpayer to keep requisite records, but rather the desire of the

CCH a Wolters Kluwer business

Commissioner to standardize a pre-determination of tax liability through the use of an industry-approved guideline."[42] "An honest and conscientious taxpayer who maintains required records has a right to expect that those records will be used in a complete audit."[43]

In *William Miller et al v. Department of Revenue*, the Department appealed from a decision of the circuit court quashing an assessment against a tavern based on an indirect audit in which the Department computed an assumed mark-up and projected sales based on purchase records provided by the taxpayer.[44] In affirming the decision, the Supreme Court of Illinois stated:

> In view of the voluminous and extensive records kept by the taxpayers in the course of their business, it cannot be said that their books and records failed to meet the requirements of the act as to form. The evidence produced to support the correctness of their records was fully as worthy of belief as the admittedly artificial result reached by the Department by the application of its formula of markup.
>
> It has been held that, in the absence of any adequate records of the taxpayer, the Department may prepare its audit from the best available other sources. *Du Page Liquor Store, Inc., v. McKibbin*, 383 Ill. 276, 48 N.E.2d 926. However, in the instant case, the Department prepared its audit upon the taxpayers' records alone, and while accepting those records as correct so far as purchases were concerned, rejected them as to sales receipts. The records here were extensive and covered all necessary steps in bookkeeping.[45]

CCH a Wolters Kluwer business

Likewise, the New York Tax Appeals Tribunal has noted that "[w]here the taxpayer establishes that the audit methodology is based on an assumption that is fundamentally flawed, the taxpayer has sustained his burden of proof and is not required to show the exact amount of taxes due [citations omitted]."[46]

Most recently, in *Charley O's, Inc., T/A Scotty's Steakhouse v. Division of Taxation*, the Tax Court of New Jersey determined that the New Jersey Division of Taxation employed an arbitrary methodology in determining that a restaurant owner owed additional sales tax and that the owner taxpayer had provided "cogent evidence" that was "definite, positive and certain in quality and quantity."[47] In *Charley O's Inc.*, the New Jersey auditor examined the taxpayer's sales journals, income tax returns, cash disbursement journals, purchase invoices, bank statements, general ledger and menu prices, but did not recall seeing or requesting the register information. Despite the information, the auditor conducted prepared workpapers based on a mark-up methodology. Prior to issuing the assessment, however, the auditor was instructed to revise the workpapers to calculate a mark-up based on the taxpayer's Corporation Business Tax (CBT) returns. Being that the gross receipts reported on these returns were higher than those reported on the taxpayer's sales tax returns, the sales tax assessment was substantially greater. In light of evidence provided by the taxpayer to substantiate lower gross receipts than those originally reported on his CBT returns, the Tax Court revised the assessment, finding that the taxpayer had overcome the burden of refuting the assessment, and stating:

> In this case, it was plain that the sales tax returns and the CBT returns could not both be correct. The auditor clearly had sufficient authority under *N.J.S.A.* 54:32B-19 to use the markup method to determine whether the plaintiff had underreported its gross receipts on the sales tax returns. There was, however, no authority for the defendant to adopt the gross receipts as reported on the CBT returns rather than the gross receipts as reported on the sales tax returns merely because it was more convenient to do so or because the use of the gross receipts reported on the CBT return produced a large sales tax liability.[48]

Noting the fact that the taxpayer could not provide the cash register tapes at the time of the audit, or at trial,[49] the New Jersey Tax Court stated that while taxpayers do have an obligation to keep detailed and true copies of invoices and receipts, "*N.J.A.C.* 18:24-2.4(a) provides, however, that when a taxpayer maintains summary records showing total receipts and taxable receipts, the taxpayer may dispose of individual sales slips, invoices, receipts, statements, memoranda of price or cash register tapes. Plaintiff's cash receipts and cash disbursements journals are such summary records. Under the Director's regulations, plaintiff's records were adequate."[50]

In conducting an indirect audit of a bar and/or restaurant using a purchase analysis to compute an assumed mark-up, some of the factors the auditor and taxpayer should consider include the following:

- Completeness and accuracy of purchase records for the entire audit period. Using unverified purchase records for less than the entire audit period may result in a statistically invalid, unreliable and unreasonable assessment. The purchase records should be verified against the taxpayer's check register and actual invoices, even if the taxpayer's records are incomplete for the entire period. The purchase records should be complete for the entire audit period, reducing the speculative data to assumptions surrounding the mark-up.
- If an incomplete set of purchase data is utilized, the auditor and taxpayer should conduct an analysis to show that the liquor purchased in the sample period is representative of the liquor purchased in other months for which liquor wholesaler records are available.
- To the extent the auditor utilizes a sample period for purposes of computing the assumed mark-up, the auditor and taxpayer should ascertain and agree as to the appropriateness of the sample periods. For example, if one week or four separate weeks from throughout the audit period are utilized, the audit report should reflect how this period is representative of all periods in the entire audit period. The analysis should also address whether holidays and seasonal sales cycles may cause a sample period not to be representative of other weeks and seasons in a year.
- To the extent the auditor utilizes a sample period for purposes of computing the assumed mark-up, the auditor and taxpayer should consider that the days within a week are not random independent samples of all days in the audit period because the same staff and inventory would carry over from one day to the next.
- The purchase analysis should also consider beginning and ending inventory in computing the cost of goods sold during the sample and audit period.

Breakage

Breakage, in general, is the loss of saleable inventory. With respect to the bar and restaurant industries, breakage may include spillage (typically overpouring), spoilage (for example, broken bottles or a bottle with a bad seal), pilferage (loss due to employee theft or loss due to customer theft), and loss due to free drinks provided by bartenders to patrons in expectation of better tips.

To the extent states provide an allowance for breakage in estimating a mark-up, they may not allow for breakage for all product types.[51] Some states may only allow for breakage on draft beer and poured liquor, but not bottled beer and wine. For example, absent taxpayer specific documentation to the contrary, the IRS has suggested a 10 percent spillage factor in computing an assumed mark-up in audits of bars and restaurants.[52] Maryland typically allows for an eight percent spillage factor on sales of liquor and wine by bars and restaurants, but no allowance for any breakage on bottled drinks, such as beer. The state typically provides no allowance for breakage by packaged-good stores either. California's audit manual provides a number of breakage factors, including unique factors for spillage and pilferage, depending on the product category and how it is poured.[53] Texas typically provides one-10th of an ounce on poured liquor (approximately eight percent) and 10 percent on poured beer. Still other states have provided no allowance for breakage where the taxpayer was unable to provide such documentation.[54]

Taxpayers should work with the auditor to obtain at least some allowance for breakage of all food and beverages sold by their establishment, be it beer, liquor or wine, as all of these product types are susceptible to some percentage of breakage. To the extent states provide an unsubstantiated allowance for breakage in estimating a mark-up for bar and restaurant sales, states typically use a spillage factor of approximately four to eight percent. While this is considered to be an industry standard, it is often not reflective of a taxpayer's actual experience. As noted by Ian Foster, an independent auditor for BEVINCO, an alcohol auditing service for bars and restaurant owners, BEVINCO audits have found that an average bar and restaurant could be missing over 20 percent of what it purchases, due to breakage factors.[55] There are similar companies, such as Ashco Beverage Auditors, that will conduct independent alcohol audits. There also exist technologies such as AccuBar[56] and Accardis,[57] which enable owners to conduct their own inventory audits and generate similar reports that track pour cost and spillage. Restaurants and bars are extremely susceptible to breakage, due to the desirable nature of the inven-

CCH a Wolters Kluwer business

tory that is maintained and the manner in which it is served. Responsible restaurant and bar owners employ various tactics such as strategically placed video camera equipment to identify, quantify and remediate the effects of such acts. In addition to these normal modes of theft prevention and breakage detection, taxpayers should consider employing independent auditors to conduct unannounced audits of their sales.[58] Not only is the goal of these audits to improve profitability, but the resulting reports may very well provide the only evidence of breakage contemporaneous to the loss.

To the extent that such audits are conducted prior to an audit (as opposed to during an audit, or in preparation for the appeal of an audit) the results of these detailed reports can prove to be very compelling evidence in contradiction to the standard breakage factors used by the state, if any were used. This taxpayer-specific data should constitute relevant "available information." Because these reports were prepared by a disinterested third party prior to the state's sales and use tax audit, they should be considered an accurate reflection of the taxpayer's actual breakage percentage, and more relevant than the standard and lower breakage factors employed by the state on liquor audits. As the Administrative Law Judge noted in *Decision of the Comptroller of Public Accounts, Hearing No. 46,176,* "That is not to say that additional credit for spillage will be disallowed, but the loss must be substantiated. To that end, a taxpayer selling alcoholic beverages is required to maintain daily summaries that document alcoholic beverages … lost to breakage or spillage showing the number of containers lost by size, brand, and class or type of drink and size … [a] written report must be prepared at the time of the loss. Rule 3.1001(j)(5)."[59]

Taxpayers should invest in a relatively sophisticated cash register or point-of-sale (POS) system, one that can provide detailed sales reports and track complimentary sales and spillage. Current systems typically have hard drives on which the data may be stored, eliminating the need to maintain voluminous hardcopies and the audit risk that occurs when register tapes are thrown away. Taxpayers should also keep weekly records of sales and losses due to breakage factors, such as spillage, spoilage and pilferage. Training employees to avoid overpouring and implementing these internal controls should pay for themselves, even if the establishment is not audited.

Pricing

As previously noted, pricing is critical in the proper utilization of the unit volume method to calculate an estimated mark-up and estimated gross sales. In addition, pricing must be analyzed by the taxpayer to ensure accuracy in the extrapolation of a mark-up calculated on the basis of a sample period. For example, the auditor may sample one month, one quarter or one year in calculating the estimated mark-up. The pricing utilized for purposes of establishing the sample period estimated mark-up should be the prices in effect during the sample period, not at the time of the audit. Secondly, to the extent that mark-up is multiplied against purchase records for periods outside of the sample period, the prices and mark-up should be adjusted to reflect pricing in effect during each separate month, quarter or year, depending on how much detailed information the taxpayer is capable of providing regarding changing prices.

Furthermore, the taxpayer should work with the auditor to ensure that pricing and estimated mark-ups are adjusted and separately calculated to reflect all distinct happy hour, seasonal and promotional pricing in effect during each separate month, quarter or year, depending on how much detailed information the taxpayer is capable of providing regarding changing prices. For example, the auditor may determine the percentage mix of happy hour sales versus regular sales based on a stand-by audit (*i.e.,* one involving field observations) or based on register tapes for one week or one month. The potential flaw with this approach is that it assumes that 100 percent of the units available for sale during the audit period were sold at the same percentage as observed during the sample period. Utilizing a one-week sample period to represent a multi-year population of happy hour sales, seasonal sales and promotional sales transactions to arrive at overall happy hour sales prices may produce skewed statistical results. Since the days of a week are contiguous, they are not independent of one another. It is likely that more reliable results would be achieved by randomly selecting periods from an entire year or audit period.

For example, in *Fox Fire Lounge v. Director of Revenue*, the Missouri Administrative Hearing Commission recalculated the assumed mark-up calculated by the auditor after the taxpayer provided sufficient pricing information as to the sales price of specific drinks, and provided sufficient evidence that happy

CCH a Wolters Kluwer business

hour prices—which accounted for 60 percent of the taxpayer's sales—were approximately 50 percent less than regular prices.[60] Likewise, in *Glandore Café, Inc. v. Commissioner*, the Massachusetts Appellate Tax Board dismissed an assessment against the bar and restaurant that was based on an indirect audit method involving computation of an assumed mark-up and a purchase analysis.[61] In so doing, the Board noted that "the mark-up figure used by the auditor was based upon grossly inflated drink prices supposedly gleaned from, what the Board has found to be, a non-existent price list."[62] Adding in the auditor's use of faulty purchase records to "reconstruct sales," the Board determined the assessment based on "such a double inference" to be "unreliable" and "tenuous under any circumstances."[63]

Alternatively, in *Department of Revenue v. Gobstompers,* the taxpayer appealed an Illinois sales tax audit assessment of the bar and restaurant that was based on an indirect audit method involving computation of an assumed mark-up and a purchase analysis.[64] While the taxpayer did not dispute the methodology employed by the auditor in the absence of any available records, the taxpayer did dispute the selling prices utilized by the auditor. The taxpayer claimed that during his initial meeting with the auditor, he provided various drink prices from memory, and claimed that various price specials were also offered at various times during the audit period. The taxpayer also produced advertising supporting the price specials. He, however, could not produce evidence as to the special prices, nor could he produce evidence as to the length of time over which the specials were offered. Noting that the ads were not sufficient to alter the liability, the Board determined that the taxpayer had not produced any documentation as to the regular or special prices, or the periods during which they were offered.

The importance of documentation and evidence in these audits cannot be overemphasized. It is only reasonable to assume that during a six-year period, prices at an establishment will have increased. Therefore, it is incumbent upon the taxpayer to provide the auditor with various prices in effect during each period of the audit. Otherwise, to the extent only current regular sales pricing is provided, the auditor may project sample results from the computation of a current sample period's assumed mark-up back against historical periods for which much lower pricing was in place, resulting in an overstated assessment of additional taxes due, not to mention interest and penalties. Again, taxpayers should invest in a cash register or POS system that can provide detailed sales and price reports by drink and/or product category, including promotional specials, happy hour prices and dates and times that these prices were in effect.

Serving Size

In addition to sales price, the serving size—or the number of drinks that can be poured from purchases—is the other critical factor in the proper utilization of the unit volume method to calculate an estimated mark-up. Recall that in developing a mark-up based on the unit volume method, the auditor will calculate the number of saleable units each liquor purchase would yield. This is accomplished by dividing the total number of ounces purchased by the number of ounces in a single serving (*e.g.,* 1.5 ounces for drinks dispensed in shot glasses and six ounces for glasses of wine). If the taxpayer does not provide accurate serving size information, the assumed mark-up will be overstated.

Current industry standards support the increased use of liquor in mixed drinks. In a study conducted by the University of Texas at Austin Addiction Science Research and Education Center, the study report noted that "while one 12-ounce beer, one 5-ounce glass of wine, and one shot (1.5 ounces) of spirits are generally equivalent beverage units … [r]estaurants and bars, however, serve oversize or over-poured drinks unless the drink comes pre-packaged (as in a bottle of beer). With wine, bars tend to give standard "doses" for a high price, to make money. With liquor, however, the more booze in a drink, the better it is! So be careful of two drinks—they may actually be three or four!"[65]

Some of the areas in which the taxpayer must work with and educate the auditor are drink mixes and serving sizes. Drink mixes such as liqueurs, grenadines and schnapps may be mixed with other liquor to make a mixed drink. For example, apple pucker would be mixed with vodka to make an apple martini. Apple pucker would never be served as a drink alone. Therefore, to compute the mark-up factoring in both the vodka and the mix improperly skews the mark-up.

With respect to serving size, in the absence of credible evidence from the taxpayer, or at least to the extent the taxpayer does not provide variable and distinct drink size information to the auditor at

CCH a Wolters Kluwer business

the outset of the audit, the auditor may calculate the estimated mark-up on the assumption, for example, that all bars use 1.5 ounces of liquor in all mixed drinks. The taxpayer, however, may prepare all or certain drinks using a minimum three ounces per drink. Some mixed drinks (*e.g.,* a Long Island iced tea) may even contain more ounces of liquor. Pursuant to the IRS Guide on Audits of Bars and Restaurants, this information must be identified during the initial taxpayer's interview, so that it may be used in calculating the mark-up.[66] The taxpayer should be prepared to provide evidence of distinct serving sizes to the auditor. Likewise, to the extent the taxpayer uses larger or distinct glass sizes, it should provide evidence of this to the auditor.[67]

Penalties

Many state tax codes provide that in instances of fraud and/or gross negligence, greater penalties may be imposed.[68] With respect to fraud and gross negligence, these typically involve an intent to evade a tax liability or an intentional disregard for one's obligations with respect to a tax liability.[69] To the extent that the state bears the burden of proving fraud, direct evidence is typically not available and therefore fraud is typically inferred by circumstantial evidence. Many state courts have determined that certain "badges of fraud" should be used in determining whether or not a taxpayer intentionally filed false returns. These badges of fraud have been adopted from federal court cases interpreting an analogous penalty provision. In *Bradford v. Commissioner*, the Ninth Circuit Court of Appeals gave a nonexclusive list of circumstantial evidence which may give rise to a finding of fraudulent intent.[70] The badges of fraud considered in a tax fraud context include:

- consistent and substantial understatements of income (or sales, in the sales tax arena);
- failure to maintain adequate records;
- implausible or inconsistent explanations of behavior, including the lack of credible testimony before a tribunal;
- concealment of assets;
- failure to cooperate fully with tax authorities;
- awareness of the obligations to file returns, report income or sales, and pay taxes; and
- failure to file returns.[71]

Once sufficient circumstantial evidence is present upon which a state may assert fraud, the burden shifts to the taxpayer to refute the presence of these badges, or indicia of fraud.

With respect to substantial underpayments of sales tax, states have met with mixed conclusions regarding taxpayers' assertions that they reasonably relied on the advice or assistance of a sales tax professional, attorney or accountant in preparing and remitting their sales tax returns. The basis for this assertion is grounded in the Internal Revenue Code (the "Code) and its supporting regulations, which provide that penalties may be imposed for, among other things, the substantial underpayment of tax, or negligence or disregard of the rules.[72] No penalties will be imposed, however, where there is a finding of "reasonable cause" and "good faith" on the part of the taxpayer.[73] Taking all of the facts and circumstances into account, there exist dozens of published decisions wherein the IRS has abated penalties for cause shown where there was a substantial underpayment involved, a failure to pay tax, and/or negligence, and the taxpayer relied on the involvement, action and advice of an accountant or tax advisor.[74]

For example, a federal court of appeals determined that the IRS abused its discretion in failing to waive penalties for substantial understatement of tax against a physician who deducted payments made to a company that provided prepaid legal services.[75] Although the payments should have been amortized rather than deducted currently, the court determined that the taxpayer had reasonable cause for the resulting understatement and that he acted in good faith. He made an effort to assess his proper tax liability by giving his disinterested tax advisors all of the information he had. Moreover, since the physician was not trained in tax law, he reasonably relied on the advice of his independent accountant and lawyer concerning the timing of the deductibility of the payments. Similarly, in *Kurzet & Kurzet*, the IRS abated penalties for reasonable cause and good faith shown, noting the "nature of the books and records which petitioners innocently but amateurishly developed and used, [and] the failure of petitioners' accountants and tax return preparers to diligently prepare the returns in question."[76]

Even with respect to negligence, there are likewise numerous decisions in which the negligence-based penalties have not been imposed, the courts or the IRS determining that the taxpayers were inexperienced in such tax matters and reasonably relied on

CCH a Wolters Kluwer business

the advice, involvement and actions of their accountant or tax advisor who prepared their return.[77] For example, in *Streber, Deloney and Davis*, a federal court of appeals ruled in favor of two siblings on whom substantial underpayment and negligence penalties had been imposed as a result of an audit. [138 F3d 216 (5th Cir., April 15, 1998) (reversing the Tax Court, 70 TCM 1604, Dec. 51,065(M), TC Memo. 1995-601)] The court determined that the two taxpayers who had inherited a large sum of money had relied on the advice of their tax attorney, having sought out the assistance of the tax advisor in good faith was acknowledgement of their lack of experience in such matters.

In *William C. King, Sr., and Margaret G. King*, the taxpayer was hit with a penalty for negligence resulting from the underreporting of his tax. Upon review, the taxpayer claimed that his books and records were in poor condition and that he hired an accountant to clean them up. Despite such efforts, he still underreported his tax. Nevertheless, the IRS determined that "this indicates an effort by petitioner to comply with the rules and regulations rather than to negligently or intentionally disregard them. Considering all the evidence and circumstances, we conclude that petitioner has shown that no part of the underpayment for 1975 was due to negligence or intentional disregard of the rules and regulations." [Docket No. 6907-79, 43 TCM 1441, TC Memo. 1982-282 (May 20, 1982)]

However, as previously stated, states have met with mixed conclusions regarding taxpayers' assertions that they reasonably relied on the advice or assistance of a sales tax professional, attorney or accountant in preparing and remitting their sales tax returns. In *Illinois Department of Revenue v. ABC Corp.,* in examining the taxpayer's intent to commit sales tax fraud, the Department of Revenue Hearings Division considered the taxpayer's argument that his reliance on the advice of his accountant constituted reasonable cause.[78] In dismissing this argument, the Department stated that there is no reasonable cause exception to a fraud penalty.[79] While not specifically adopting the badges of fraud, in considering all other indicia of fraud, the Department noted that "the consistency, duration and extent of ABC's understatement of its monthly taxable gross receipts" provided ample circumstantial evidence of fraudulent intent.[80]

States have also met with mixed conclusions regarding taxpayers' assertions as to other indicia of fraud. The taxpayer in *In re West Greenville Liquors, Inc.* contested the imposition of the penalty on the basis that he relied on the advice of his accountant who prepared the returns to accurately report his sales tax.[81] The Administrative Law Judge disagreed with the taxpayer, noting the substantial underpayment of sales taxes over a prolonged period of time and the taxpayer's "considerable experience" in the retail liquor industry, which established inconsistent explanations as to his behavior and an awareness of his obligations.

In *In re Waples dba Jack's Restaurant*, the New York Tax Tribunal examined several of the indicia or badges of fraud. [82] In upholding the imposition of the fraud penalty, the tribunal found that the decisive factor was the taxpayer's consistent and substantial underpayment of tax. In addition to this factor, the tribunal found the taxpayer's failure to maintain a bank account, his cash-only transactions, his failure to file tax returns, and his failure to maintain adequate business records were sufficient indicia of fraudulent intent to evade taxes.

In *New Corner Bar, Inc. v. Commissioner of Revenue*, the Minnesota Tax Court stated that "because direct proof of intent is usually not available, tax fraud may be shown by circumstantial evidence."[83] The Tax Court therefore established fraud from the transactions and the actions of the taxpayers. In evaluating the indicia of fraud, the court found a knowledge of the tax law from the taxpayer's experience as a business owner and operator. The court also found incomplete records, a pattern of consistent and substantial underpayment of taxes, and implausible or inconsistent explanations of behavior, in that the taxpayer failed to convincingly explain his bar's operations and tax reporting practices.[84]

Alternatively, in *In re Bailo Grill, Inc.*, the New York State Tax Commission determined that the Audit Division had not met its burden of proving every element of intentional or willful acts or omissions amounting to fraud by "clear and convincing evidence."[85] The Commission found that the taxpayer's understatements were "not substantial over such a length of time as to indicate a pattern or scheme."[86]

And in *Decision, Hearing No. 12,912*, the Texas Comptroller considered the merit of the Sales Tax Division's imposition of the fraud penalty based on indicia of fraud.[87] The Division cited three factors as a basis for its assertion of fraud: a substantial and consistent underreporting of income, the failure to maintain records, and inconsistency in the amounts

CCH a Wolters Kluwer business

reported to the Comptroller and the IRS. The Comptroller determined that fraud was not present. This was evidenced by the taxpayer's lack of sophistication and education, its lack of adequate records, and its inconsistent tax filings.

Conclusion

There are a number of opportunities to contest specific aspects of the audit assessment and methodologies employed by the state in estimating the gross taxable sales and additional sales tax due. Specifically, some of these opportunities relate to the method used by the auditor in conducting a purchase analysis and computing the mark-up; the assumptions made by the auditor and any sampling employed in conducting a purchase analysis and computing the mark-up; the breakage factors, such as spillage, spoilage and pilferage, used by the auditor in computing the mark-up; the assumptions made as to the pricing and serving sizes during the sample period and over the entire audit period; and whether there is sufficient direct evidence or circumstantial evidence (*e.g.,* badges or indicia) to warrant the imposition of a fraud penalty.

The importance of documentation and evidence in these audits cannot be overemphasized. Bar and restaurant owners should invest in a relatively sophisticated cash register or POS system, one that can provide detailed sales reports and track complimentary sales and spillage. Owners should also consider conducting regular inventory audits contemporaneous to the periods of loss. Also, owners should keep weekly records of sales and reports of losses due to breakage factors, such as spillage, spoilage and pilferage. All sales register reports, breakage reports and purchase records should be maintained for at least four years for sales tax audit purposes. Implementing these internal controls should pay for themselves in terms of increased awareness of areas that negatively impact profits, even if the establishment is not audited. To the extent an establishment is audited, taking such actions will demonstrate that the company has proactively taken the steps expected of a reasonable person in regards to their sales and use tax obligations, which should serve to mitigate any potential penalties that could be imposed.

When faced with a sales tax liquor audit and statistical sampling audit methods, taxpayers should seek the counsel of a sales tax professional specializing in sales tax liquor audits, rather than their day-to-day accountants or attorneys. These particular professionals are well-versed in the audit methods of the state, and the evidence necessary to rebut the presumed accuracy of the assessment and any indicia that fraud is involved. Furthermore, doing so at the outset of the audit may significantly reduce the potential assessment, as the taxpayer will have an experienced advocate working on its behalf with the auditor to yield the optimal audit results.

CCH a Wolters Kluwer business

Endnotes

* The views set forth in this article are the personal views of the author and do not necessarily reflect those of any organization with which the author is associated.

** The author wishes to thank Edward H. Ben, CPA for his assistance and advice in preparation of this article and in co-representing clients in sales tax liquor audit cases. Ed is a partner with SC&H State & Local Tax Consulting in Baltimore, Md., with more than a decade of experience in the area of sales and transaction tax consulting. The author also wishes to thank Chris Tracy and Amanda Immler for their research. Last, and most important, the author thanks his wife, Erin, and two daughters, Mackenzie and Teagan, for their love, support and endurance.

1 *Compendium of Government Finances: 2002, 2002 Census of Governments,* Vol. 4, No. 5, Government Finances, U.S. Census Bureau, (October 2005).

2 Cline, Fox, Neubig and Phillips*, Total State and Local Business Taxes, Nationally 1980—2005, by State 2002—2005, and by Industry 2005* (July 2006).

3 For example, see Alabama—*Pelican Pub & Raw Bar, LLC v. Alabama Department of Revenue*, No. S. 00-86, Alabama Department of Revenue, Admin. Law Div. (Dec. 15, 2000); Arizona—*Duckworth dba Shenanigan's Bar & Grill, and SBG, Inc. v. Arizona Department of Revenue,* Nos. 1739-98-S and 1740-98-S, Az. Bd. of Tax App. (March 29, 1999); California—*Riley B's v. State Bd. of Equalization,* 61 Cal. App 3d 610 (Ca. Ct. App. 1976); Connecticut—*Constantine and Larcon dba Bach Dor Disco Café v. Commissioner*, CV-91-0390484 S, Connecticut Tax Court (May 23, 1994); Illinois—*Illinois Department of Revenue v. ABC Saloon, Inc.,* ST 03-12, Il. Dept of Rev. Hearings (July 28, 2003); Illinois—*Illinois Department of Revenue v. ABC Corp.,* ST 02-16, Il. Dept of Rev. Hearings (May 20, 2002); Illinois—*Illinois Department of Revenue v. Gobstompers, Inc.,* ST 00-13, Il. Dept of Rev. Hearings (Feb. 28, 2000); Massachusetts—*Food Service Associates, Inc. and Maxwell v. Commissioner,* Nos. 255109 and 255110, Mass. App. Tax Bd. (May 11, 2001); Massachusetts—*Chef Chang's House, Inc. v. Commissioner,* No. 152100, Mass. App. Tax Bd. (Dec. 18, 1996); Massachusetts—*Glandore Café, Inc. v. Commissioner,* No. 1931444, Mass. App. Tax Bd. (Sept. 7, 1994); Michigan—*Catherine Skope v. Department of Revenue,* No. 197, Mich. Bd. of Tax App. (March 23, 1950); Minnesota—*New Corner Bar, Inc. v. Commissioner,* No. 7221 R, Minn. Tax Ct. (Aug. 29, 2001); Missouri—*Fox Fire Lounge v. Director of Revenue,* No. RS-88-1241, Mo. Admin. Hearing Comm'n. (July 28, 1989); New Jersey—*Joseph G. Ridolfi t/a Hub Bar and Liquor Store v. Director,* 1 NJ 198 (N.J. Tax Ct. 1990); New Mexico—*Felipe A. Archuleta dba Stockman's Saloon v. Commissioner,* 504 P.2d 638 (N.M. Ct. App. 1972); New York—*In re West Greenville Liquors, Inc.,* No. 812376, N.Y. Tax App. Tribunal (May 9, 1996); New York—*In re*

Endnotes

Sundown Meat, Fish & Liquor Co., Inc., Nos. 802322, 802382 and 802383, N.Y. Tax App. Tribunal (Sept. 24, 1992); New York—*In re Waples dba Jack's Restaurant,* No. TSB-D-90(3)S, N.Y. Tax App. Tribunal (Jan. 11, 1990); New York—*In re Caleri dba Villa Capri Restaurant,* No. 801486, N.Y. Tax App. Tribunal (Aug. 11, 1988); New York—*In re Bailo Grill, Inc.,* TSB-H-85(223)S, N.Y. Tax Comm'n (Dec. 6, 1985); Ohio—*Wiedt and Wiedt Tavern, Inc., dba Kenilworth Tavern v. Commissioner,* No. 98-T-97, Ohio Bd. of Tax App. (Dec. 10, 1999); Ohio—*Clubhouse Sports Bar & Grill v. Commissioner,* No. 97-M-534, Ohio Bd. Tax App. (Nov. 20, 1998); South Dakota—*City of Lennox dba v. Secretary of Department of Revenue,* 278 NW2d 635 (N.D. 1978); Texas—*Decision of the Comptroller of Public Accounts,* No. 45,188, Dec. 20, 2005; Texas—*Decision of the Comptroller of Public Accounts,* No. 44,891, Nov. 3, 2005; Texas—*Decision of the Comptroller of Public Accounts,* No. 40,163, Jan. 29, 2003; Texas—*Decision of the Comptroller of Public Accounts,* No. 41,139, Aug. 22, 2002; Washington—*In re Correction of Assessment 98-065,* 17 WTD 359, Wa. Dept. of Rev. (April 27, 1998); Wyoming—*In re Waugh dba Capt'n Ron's Rodeo Bar,* No. 2003-24, Wyo. State Bd. of Equalization (May 11, 2004).

[4] Andy Opsahl, *Crack Down,* Government Technology, (Dec. 8, 2005), available online at *www.govtech.net/magazine/channel_story.php/97504.*

[5] *Id.*

[6] *Comptroller Schaefer to Expand Alcohol Audit Project Throughout State,* Comptroller of Maryland, (June 13, 2005), available online at *www.marylandtaxes.com/publications/nr/current/pr113.asp.*

[7] *Bars & Restaurants Audit Manual,* Chapter 8, California State Board of Equalization (February 2001).

[8] *SBE Publication 24 Tax Tips for Liquor Stores,* California State Board of Equalization (January 2003).

[9] *Id.*

[10] See *www.myflorida.com/dor/taxes/bar_lounge.html.*

[11] *See, e.g., In re West Greenville Liquors, Inc.,* No. 812376, N.Y. Tax App. Tribunal (May 9, 1996); *In re Sundown Meat, Fish & Liquor Co., Inc.,* Nos. 802322, 802382 and 802383, N.Y. Tax App. Tribunal (Sept. 24, 1992); *In re Waples dba Jack's Restaurant,* No. TSB-D-90(3)S, N.Y. Tax App. Tribunal (Jan. 11, 1990); *In re Caleri dba Villa Capri Restaurant,* No. 801486, N.Y. Tax App. Tribunal (Aug. 11, 1988); *In re Bailo Grill, Inc.,* TSB-H-85(223)S, N.Y. Tax Comm'n (Dec. 6, 1985).

[12] *2005 Annual Report,* Ohio Department of Taxation (April 2006).

[13] *See, e.g., Decision of the Comptroller of Public Accounts,* No. 45,188, Dec. 20, 2005; *Decision of the Comptroller of Public Accounts,* No. 44,891, Nov. 3, 2005; *Decision of the Comptroller of Public Accounts,* No. 40,163, Jan. 29, 2003; *Decision of the Comptroller of Public Accounts,* No. 41,139, Aug. 22, 2002.

[14] *Texas Mixed Beverage Gross Receipts Tax Guide*, Texas Comptroller of Public Accounts (July 2000).

[15] *Accommodations & Food Services Industry Series, U.S. Census Bureau, Food Services & Drinking Places: 2002 Economic Census* (October 2004).

[16] *Supra* note 1.

[17] See C.A. Albrecht, W.S. Albrecht and J.D. Dunn, *Conducting a Pro-Active Fraud Audit: A Case Study,* Journal of Forensic Accounting, Vol. II, (2000) at 203-218, for a more thorough discussion of the fraud hypothesis testing approach.

[18] James T. Loftus and Thomas E. Vermeer, *Proactive Fraud Auditing: Technology, Fraud Auditing & Liquor,* Journal of Forensic Accounting, Vol. IV (2003): at 307-310.

[19] *See IRS's Market Segment Specialization Program Audit Technique Guide—Bars and Restaurants*, Revenue 11-2002, Training 3149-118, TPDS No. 83849L (April 9, 2003)*; Bars and Restaurants*, Department of the Treasury—IRS, (released February 1995).

[20] Md. Code §13-407; The Comptroller's audit manual states that if "sales records appear incomplete, inaccurate, or produce illogical results it may be necessary to compute gross sales using a 'purchase analysis.'" *Maryland Comptroller's Audit Manual,* at 34.

[21] *Maryland Comptroller's Audit Manual,* at 34.

[22] *Bars & Restaurants Audit Manual,* Chapter 8, §0803.05, California State Board of Equalization (February 2001).

[23] *Riley B's, Inc. v State Board of Equalization,* 61 Cal. App. 3d 610 (1976).

[24] 34 Texas Admin. Code §3.282(k).

[25] *Decision of the Comptroller of Public Accounts,* No. 45,188, Dec. 20, 2005.

[26] *Texas Mixed Beverage Gross Receipts Tax Guide*, Section III.B, p. 5, Texas Comptroller of Public Accounts (July 2000).

[27] See, *e.g.,* note 2.

[28] See, *e.g.,* Ariz. Rev. Stat. §42-1104(B)(2), providing that the four-year statute is increased to six years if the underpayment is greater than 25 percent; Cal. Rev. & Tax Code §6487, providing that no statute of limitations applies to cases involving fraud or intentional evasion of tax. Md. Code §13-1102(b)(1)(i) provides that "[a]n action to recover admissions and amusement tax or sales and use tax may be brought at any time if there is proof that the tax is not paid due to fraud or gross negligence." Otherwise, the standard four-year statute of limitations on actions to recover taxes shall be applied. Md. Code §13-1102(a). Pursuant to §13-1102(b)(1)(ii) "[a]n underpayment of 25% or more of the sales and use tax due is prima facie evidence of gross negligence." Pursuant to N.Y. Tax Law §1147(b), no statute of limitations exists in cases of fraud, usually involving an intent to evade tax.

[29] Md. Code §13-703.

[30] Cal. Rev. & Tax Code §§6511 and 6514.

[31] N.Y. Tax Law §1145(a)(2).

[32] Dr. Will Yancey, PhD, CPA, *Statistical Sampling in Sales and Use Tax Audits,* ¶110.02 (CCH, 2002).

[33] *Id.*

[34] *See, e.g., Paine v. State Bd. of Equalization* (1982) 137 Cal. App. 3d 438, 442; *Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal. App. 3d 739, 744) (providing that in order to meet this burden the taxpayer must prove both (1) the assessment is incorrect, and (2) proper amount of the tax. *See also, Shelly S. Wright, t/a T&M Cut Rate & Lounge vs. Comptroller of the Treasury,* MTC No. 03-SU-00-0416 (unreported); *In re West Greenville Liquors, Inc.*, No. 812376, N.Y. Tax App. Tribunal (May 9, 1996); *In re Caleri dba Villa Capri Restaurant,* No. 801486, N.Y. Tax App. Tribunal (Aug. 11, 1988).

[35] MTC No. 03-SU-00-0416 (unreported).

[36] Nos. 255109 and 255110, Mass. App. Tax Bd. (May 11, 2001).

[37] 20 Mass. App. Tax Bd. Rep. 67, 76 (1996).

[38] *Id,* at 71.

[39] *Id.*

[40] *Family Deli of Bellmore, Inc.,* DTA No. 810719, N.Y. Div. of Tax Appeals, ALJ Unit (July 20, 1995).

[41] *Constantine and Larcon dba Bach Dor Disco Café v. Commissioner*, CV-91-0390484 S, Conn. Tax Ct. (May 23, 1994)

[42] *Id.*

[43] *Id.* (citing *Ace Provision & Lunch Supply v. Chu*, 523 N.Y.S. 2d 208, 210 (N.Y. App. Div. 1987).

[44] 97 NE2d 788 (Ill. 1951). *See Department of Revenue v. Stromboli, Inc.* ST 98-35, Illinois Department of Revenue (Jan. 1, 1998) (revising assessment based on indirect method where taxpayer provided credible books and records).

[45] *Id.*

[46] *Matter of Bernstein-On-Essex*, N.Y. Tax Appeals Tribunal (Dec. 3, 1992).

[47] *Charley O's Inc., T/A Scotty's Steakhouse v. Division of Taxation*, No. 002836-2002, N.J. Tax Ct. (July 12, 2006).

[48] *Id.*

[49] The taxpayer claimed that all register tapes

CCH a Wolters Kluwer business

ENDNOTES

were provided to his accountant at the time of the audit, but the auditor denied ever seeing them. The accountant, between the time of the audit and the trial, was incarcerated in an unrelated matter and the records were nowhere to be found.

50 No. 002836-2002, N.J. Tax Ct. (July 12, 2006).

51 See, *e.g.,* Alabama—*Pelican Pub & Raw Bar, LLC v. Alabama Department of Revenue*, No. S. 00-86, Alabama Department of Revenue, Admin. Law Div. (Dec. 15, 2000) (five percent spillage factor for all drinks was reasonable); New Mexico—*Felipe A. Archuleta dba Stockman's Saloon v. Commissioner*, 504 P.2d 638 (N.M. Ct. App. 1972) (10 percent spillage factor allowed); New York—*In re West Greenville Liquors, Inc.*, No. 812376, N.Y. Tax App. Tribunal (May 9, 1996) (two percent spillage factor for loss and theft); New York—*In re Sundown Meat, Fish & Liquor Co., Inc.,* Nos. 802322, 802382 and 802383, N.Y Tax. App. Tribunal (Sept. 24, 1992) (15 percent spillage on liquor); Washington—*In re Correction of Assessment 98-065*, 17 WTD 359, Wa. Dept. of Rev. (April 27, 1998) (eight percent spillage on some products); Wyoming—*In re Waugh dba Capt'n Ron's Rodeo Bar*, No. 2003-24, Wyo. State Bd. of Equalization (May 11, 2004) (10 percent spillage factor on some products).

52 *Supra* note 19.

53 *Bars & Restaurants Audit Manual*, Chapter 8, California State Board of Equalization (February 2001).

54 See, *e.g.,* New Jersey—*Joseph G. Ridolfi t/a Hub Bar and Liquor Store v. Director*, 1 NJ 198 (N.J. Tax Ct. 1990) ; North Dakota—*City of Lennox dba v. Secretary of Department of Revenue*, 278 N.W.2d 635 (N.D. 1978).

55 Ian Foster, *Tax Audits Threaten Bar and Restaurant Owners*, BEVINCO's BOOZ NOOZ, Vol. 2, Issue 7.

56 AccuBar uses a palm-type computer with a barcode scanner to read the UPC labels. A silhouette of the bottle appears on the screen of the handheld device and the user indicates on the image where the fluid level in the bottle is. The computer instantly computes the volume and extends it by the cost per ounce.

57 Accardis features a hand-held microprocessor with a built-in keypad, a four-line liquid character display and a laser scanner. The device reads UPC codes, interfaces with an electronic scale, and downloads the audit data into your computer. The Accardis system even has an ancillary system capable of measuring the amount of beer left in kegs without moving or lifting them.

58 These audits are conducted after normal operating hours so as not to alert employees of their presence in an effort to obtain results that are representative of normal operations. Using specialized software and calibrated scales, auditors weigh all open liquor, wine and draft beer and take detailed physical counts of all full bottles on the premises every night for the entire audit period, which is typically a week. The auditors then compare the exact amount of liquor that has been used during the reporting period (*e.g.,* one week) against the amount of liquor the bar owner's POS system has recorded as being sold. A detailed report is then generated that highlights all spillage percentages by product type. These reports also provide bar owners with an analysis of pour costs by product type and a summary of the amount of revenue lost as a result of the spillage.

59 *Decision of the Comptroller of Public Accounts,* Hearing No. 46,176, March 27, 2006.

60 *Fox Fire Lounge v. Director of Revenue*, No. RS-88-1241, Mo. Admin. Hearing Comm'n. (July 28, 1989).

61 *Glandore Café, Inc. v. Commissioner*, No. 1931444, Mass. App. Tax Bd. (Sept. 7, 1994).

62 *Id.*

63 *Id.,* citing *Suprenant v. Comm'r of Revenue*, 14 Mass. App. Tax. Bd. Rep. 12 (Docket No. 156519, Oct. 25, 1991).

64 ST 00-13, Il. Dept of Rev. Hearings (Feb. 28, 2000).

65 *Study 291*, The University of Texas at Austin Addiction Science Research and Education Center (July 25, 2005).

66 *IRS's Market Segment Specialization Program Audit Technique Guide—Bars and Restaurants*, Revenue 11-2002, Training 3149-118, TPDS No. 83849L (April 9, 2003)*; Bars and Restaurants*, at 24, Department of the Treasury—IRS (released February 1995).

67 *Clubhouse Sports Bar & Grill v. Commissioner,* No. 97-M-534, Ohio Bd. Tax App. (Nov. 20, 1998) (upholding the assessment against a taxpayer on the basis that the taxpayer provided no evidence as to larger drink sizes or price specials).

68 See, *e.g.,* Md. Code §13-703; Cal. Rev. & Tax Code §§6511 and 6514; N.Y. Tax Law §1145(a)(2); RCW §82.32.090.

69 See BLACK'S LAW DICTIONARY, at 660, 1033 (6th ed. 1990). See also, Alabama—*Susan's Restaurant v. Alabama Department of Revenue*, Docket No. S. 91-201, Alabama Department of Revenue, Admin. Law Div. (July 1, 1992); Illinois—*Illinois Department of Revenue v. ABC Saloon, Inc.,* ST 03-12, Il. Dept of Rev. Hearings (July 28, 2003); Illinois—*Illinois Department of Revenue v. ABC Corp.,* ST 02-16, Il. Dept of Rev. Hearings (May 20, 2002); Maryland—*Genie & Company v. Comptroller*, 668 A.2d 1013 (Md. Ct. Spec. App. 1995); Minnesota—*New Corner Bar, Inc. v. Commissioner*, No. 7221 R, Minn. Tax Ct. (Aug. 29, 2001); New York—*In re Waples dba Jack's Restaurant,* No. TSB-D-90(3)S, N.Y. Tax App. Tribunal (Jan. 11, 1990); New York—*In re Bailo Grill, Inc.*, TSB-H-85(223)S, N.Y. Tax Comm'n (Dec. 6, 1985); Washington—*In re Correction of Assessment 98-065*, 17 WTD 359, Wa. Dept. of Rev. (April 27, 1998).

70 796 F.2d 303, 307 (9th Cir. 1986).

71 *Id.*

72 Code Sec. 6662; Reg. 1.6662.

73 *Id.*

74 For other cases in which penalties for a substantial underpayment of tax were abated because the taxpayer reasonably relied the advice of an attorney or accountant, *see, e.g. Meleca Vulic*, Docket No. 14859-02 . TC Memo. 2004-51 (March 8, 2004); *John M. Merritt and Carolyn Merritt. J.M.A. & Associates, P.C.,* Docket Nos. 16214-98, 16715-98, TC Memo. 2003-187, 85 TCM 1550 (June 30, 2003); *Doyce D. Gentry*, Docket No. 10967-97, TC Memo. 2001-295, 82 TCM 865 (Nov. 6, 2001); *James E. Zurcher, Jr.*, Docket No. 5797-96., TC Memo. 1997-203, 73 TCM 2697 (May 5, 1997); *see also, James P. De Ocampo and Marla L. De Ocampo*, Docket No. 11624-94., TC Memo. 1997-161, 73 TCM 2490 (April 1, 1997); *J. Brent Haymond and Janis S. Haymond*, Docket No. 13024-95, TC Memo. 1997-289, 73 TCM 3179, (June 26, 1997); *Joel Hillman*, Docket No. 3706-96., TC Memo. 1999-3, 77 TCM 1193 (Jan. 5, 1999); *Plains Petroleum Company and Subsidiaries*, Docket No. 25636-96, TC Memo. 1999-241, 78 TCM 130 (filed July 23, 1999).

75 *George S. Mauerman,* 22 F3d 1001 (10th Cir., April 25, 1994) (reversing the Tax Court, 65 TCM 1772 (TC Memo. 1993-23)).

76 *Stanley M. Kurzet and Anne L. Kurzet*, Docket No. 27982-91, TC Memo. 1997-54, 73 TCM 1867 (Jan. 29, 1997).

77 For other cases in which penalties for negligence were abated because the taxpayer reasonably relied the advice of an attorney or accountant, *see, e.g., Caspian Consulting Group, Inc.*, Dkt. No. 18124-03 , TC Memo. 2005-54 (March 23, 2005); *Everett J. Diers*, Docket No. 619-01, TC Memo. 2003-229, 86 TCM 207 (July 31, 2003); *Christopher Y. Kimm*, Docket No. 4102-01, TC Memo. 2003-215, 86 TCM 101 (July 17, 2003); *Computer Power Software Group, Inc.*, Docket Nos. 555-00 , 1821-00, TC Memo. 2003-152, 85 TCM 1401 (May 27, 2003); *Russell E. Ballantyne and*

CCH a Wolters Kluwer business

ENDNOTES

Clarice Ballantyne, Docket Nos. 14848-99, 16346-99, TC Memo. 2002-160 (June 24, 2002); *John Favia,* Docket No. 9585-00, TC Memo. 2002-154 (June 18, 2002); *Mark R. and Judith R. Barton*, Docket No. 7425-90, TC Memo. 1992-25, 63 TCM 1797 (Jan. 13, 1992); *Warwick Housden*, Docket No. 33163-88, TC Memo. 1992-91, 63 TCM 2063 (Feb. 13, 1992); *Sears Imported Autos, Inc.*, Docket No. 13764-90, TC Memo. 1992-307, 63 TCM 3075 (June 1, 1992).

[78] ST 02-16, Il. Dept of Rev. Hearings (May 20, 2002).

[79] *Id.*

[80] *Id.*

[81] No. 812376, N.Y. Tax App. Tribunal (May 9, 1996).

[82] TSB-D-90(3)S, N.Y. Tax App. Tribunal (Jan. 11, 1990).

[83] No. 7221 R, Minn. Tax Ct. (Aug. 29, 2001).

[84] *Id.*

[85] TSB-H-85(223)S, N.Y. Tax Comm'n (Dec. 6, 1985).

[86] *Id.*

[87] Texas Comptroller of Public Accounts (April 29, 1983).

This article is reprinted with the publisher's permission from the JOURNAL OF STATE TAXATION, a bimonthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher's permission is prohibited. To subscribe to the JOURNAL OF STATE TAXATION or other CCH Journals please call 800-449-8114 or visit wwwCCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH or any other person.

™ CCH
a Wolters Kluwer business

©2006 CCH. All Rights Reserved.