

Comptroller's Office Increases Sales Tax Audits; *Part 4 of 5*

What You Must Know

by
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In this fourth installment to our five-part series covering the Maryland Comptroller's sales tax audits of alcohol beverage license holders, we address other factors (e.g., pricing, serving size) that can significantly impact the audit methodologies employed by the Comptroller and what measures taxpayer's must take in order to counter these factors.

As we previously noted in the three previous editions of the *Maryland Beverage Journal*, the Comptroller is utilizing distributor sales data to target alcohol beverage license holders for sales tax audits. Under this program, the Comptroller has audited over 100 bars, restaurants, and other license holders in the past five years,

generating nearly \$50 Million in assessments. To the extent your establishment is audited, however, there are several means 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. This five-part series on the Comptroller's sales tax audit initiative addresses various aspects of the audit methodology and what the taxpayer can do to defend themselves before, during and after an audit.

Recall that under a "purchase mark-up" audit methodology (discussed in the second article of this series), the auditor will obtain pricing from the establishment owner, and make several assumptions regarding the product sales. The auditor then multiplies distributor sales x drink size x drink price to estimate a product "mark-up" for the sample period. The sample period "mark-up" is then multiplied by distributor sales for the audit period to calculate estimated gross sales for the audit period. In addition to breakage, the auditor's assumptions typically include pricing, and serving size of drinks poured per bottle. Needless to say, these assumptions can inaccurately and significantly impact the audit results.

Pricing

As noted above, pricing is a critical factor in calculating an estimated mark-up and estimated gross sales under a "purchase mark-up" audit methodology. Therefore, if pricing information used does not accurately reflect the pricing of drinks during any period of the audit, these inaccuracies can

significantly skew the audit results. As such, the taxpayer must analyze pricing to ensure accuracy of pricing in the sample and in the extrapolation of a mark-up calculated on the basis of a sample period. A taxpayer's short checklist should include:

Ensure that the pricing used for the sample period estimated mark-up should be the pricing in effect during the sample period, not at the time of the audit, which may be several years later.

Endeavor to provide unique pricing in effect during each separate month, quarter, or year, so that a separate mark-up is calculated for each period in which pricing is unique (this will obviously depend on how much detailed information the taxpayer desires to provide/is capable of providing regarding changing prices).

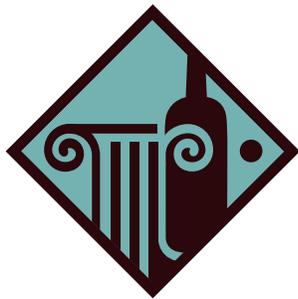
Ensure that separate mark-ups are calculated to reflect all distinct happy hour, seasonal, and promotional pricing in effect during each separate month, quarter, or year. For example, if the auditor determines the percentage mix of happy hour sales versus regular sales based on a stand-by field observations or register tapes for one week, or one month, this approach assumes the same percentage for all periods 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 audit period sales prices may produce skewed statistical results.

Taxing authorities and courts considering such assertions have thrown assessments out on the basis that such audit assumptions are unreliable and tenuous. However, in the absence of reliable records to support a taxpayer's assertions that the auditor's pricing assumptions are unreliable or produce inaccurate results, taxing authorities are empowered to rely on any available means of estimating a taxpayer's liability, despite how unreasonable the results may be. As such, the importance of documentation and evidence in these audits cannot be overemphasized.

Serving Size

In addition to sales price, the serving size

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- or the number of drinks that can be poured from a purchased bottle/keg/case - is another critical factor in the proper utilization of the "purchase mark-up" audit methodology. Recall that in developing a "mark-up," the auditor will calculate the number of saleable units in each liquor purchase based on serving size. This factor is multiplied by pricing and purchases to determine the assumed "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 specific serving sizes to the auditor, the auditor may calculate the "mark-up" on the assumption that taxpayer uses 1.5 ounces of liquor in all mixed drinks, 6 ounces for wine and 12 ounces for beer. If the taxpayer actually uses a 3.0 ounce pour for all mixed drinks, a 9.0 ounce pour for wine, and a 16 ounce and 22 ounce pour for all draft beer, this must be reflected in the auditor's schedules. If the taxpayer does not provide accurate serving size information, the assumed "mark-up" and resulting assessment will be overstated.

It is reasonable to assume that during a four year period, prices at an establishment will increase. Therefore, the taxpayer must provide the auditor with various prices in effect during each period of the audit. In addition, the taxpayer must provide and verify the serving sizes used by the auditor in estimating the "mark-up." Otherwise, inaccuracies in these assumptions may result in an overstated "mark-up" and assessment of taxes, not to mention interest and penalties. Taxpayers should invest in a cash register or point-of-sale (POS) system that can provide detailed sales and price reports by drink and size, including promotional specials, happy hour prices and dates and times that these prices were in effect.

In the last article in this series, the author will discuss penalties and interest, the basis for their imposition, and their impact on the overall assessment. The author will also address measures to seek abatement or reduction of both penalties and interest, which can significantly reduce the cost of your establishment's potential assessment, should you be audited.

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Absolut Digital Postcard Promotion

Representatives from Republic National Distributing Company (RNDC) were recently at Stalking Horse in Baltimore's Federal Hill area promoting Absolut Digital Postcards. As explained by Lisa Dillard of RNDC "The Absolut Digital Postcard promotion is a program where consumers who try-out the different Absolut flavors are offered the opportunity to have their picture taken and a postcard is then created that they can send to friends and family for the holidays." She added that, "everyone in attendance had a good time and were also very enthusiastic about the postcard promotion."



Kelly Ziegler, a spokes model from Tastings, is shown with some of the customers at Stalking Horse.



Here's bartender Sean at Stalking Horse who entertained all of the customers at the promotion.



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