Comptroller's Office Increases Sales Tax Audits:

What You Must Know

by
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The Internal Revenue Service and numerous states regularly conduct tax audits of bars, package good stores, restaurants and other beverage alcohol license holders.

In addition, The Maryland Comptroller is in the midst of an aggressive project targeting license holders and operators for unpaid sales tax. According to the State Comptroller's office, "The Comptroller's Office persuaded all 74 beverage alcohol 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. Auditing software purchased from ACL Services was used to juxtapose the two sides, revealing underreported sales from some retailers. Thanks to cooperation from the alcohol beverage industry, we can compare product deliveries to liquor stores and what they, in turn, report as sales… 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."

More specifically, since 2002, the Comptroller's office has conducted over 100 audits under this program, over half of the cases resulting in fraud penalties, and a quarter of them resulting in assertions of gross negligence, generating nearly $50 million in tax, interest and penalty assessments. The assertion of civil fraud can result in a penalty of up to 100 percent of the tax due, effectively doubling the tax assessed. In addition, the assertion of fraud and gross negligence (automatic if the assessed tax is greater than 25% of tax previously reported) can result in a waiver of the statute of limitations, which is normally four years. As such, a license holder and/or the operator can be assessed for decades of taxes, including taxes for periods prior to their involvement in the establishment. To date, the Comptroller has audited license holders and establishments in Baltimore City and Baltimore, Prince George's, Montgomery, Washington, and Worcester (small-scale review) counties, with intentions to target establishments in each county, as well as reviewing those establishments already assessed to verify increased compliance. In one county, every case involved the imposition of a 100% fraud penalty and waiver of the four-year statute of limitations.

As is the case in most IRS and state tax audits of bars, restaurants and packaged goods establishments, the Maryland Comptroller will employ a "purchase mark-up" to compute gross sales and taxable sales by estimating a mark-up and marking up inventory purchases for a sample period, assuming all inventory purchases are sold. Given the inherent limitations of this method – to be addressed herein - taxpayers must work to present alternative reliable records to be audited. To the extent the distributor records are used as the basis of a potential assessment, taxpayers must work with the auditor to ensure that the products purchased in the sample period is representative of the product purchased in other months for which wholesaler records are available. Taxpayers must also work with the auditor to ensure that such factors as breakage, changes in pricing and serving size are all accurately reflected in the computation of the mark-up, as this estimate will then be used to project additional tax owed. Any inaccurate inflation in the sample period mark-up will therefore be projected against the total population, resulting in an exponentially exaggerated inflation of the projected taxable sales.

The best means to defend your establishment against an audit is to minimize the risk that you will be targeted in the first place, by maintaining complete, accurate and reliable records. This means proactively taking steps to ensure that you are capturing and reporting all taxable sales, and maintaining all documentation. This also means accurately maintaining inventory records and ensuring your purchases are in fact sold by you, and if not, what items resulted in breakage to you. Owners should consider investing in a computerized point-of-sale (POS) system, and developing specific regular reports to track specific data fields that the Comptroller may request for sales tax audit purposes. Owners should also consider utilizing a third-party inventory assessor to accurately track inventory and breakage by category. In addition to improving profitability, such efforts and reports may be presented during or after an audit to rebut audit assumptions or assessments. Taking such steps will also demonstrate that the owner has taken reasonable actions to meet their tax obligations, which should mitigate potential penalties imposed.

Unfortunately, many bars and restaurants in every county will be targeted for a beverage sales tax audit by the Comptroller, and dozens may receive assessments. Enforcement of these assessments can include liens against taxpayers' licenses, personal assets and bank accounts. To the extent your establishment is audited, 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.

In this five-part series over the next several editions of the *Beverage Journal*, the author evaluates the Comptrollers' audit methodology, and its limitations. The author also evaluates factors and criteria that may negatively and significantly impact the audit results and therefore your establishment's potential assessment, to the extent you are targeted for audit. In each article in this series, the author will address specific factors that may impact your audit, and what you must know in order to directly and positively impact the audit results. The author also addresses specific measures owners can adopt to minimize their audit risk, and improve profitability while doing so.

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