Comptroller's Office Increases Sales Tax Audits; *Part 2 of 5*

What You Must Know

by
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As we previously noted in October's edition of the Maryland Beverage Journal, the Maryland Comptroller's office is targeting bars, restaurants, and other alcohol beverage license holders for sales tax audits, by comparing distributor sales per license holder to each license holder's reported taxable sales. The Comptroller has conducted over 100 audits under this program, generating nearly $50 Million in assessments over the past five years.

Unfortunately, many license holders in every county will be audited by the Comptroller, and many will be assessed, enforcement of which can include liens against taxpayers' liquor licenses, personal assets and bank accounts. To the extent your establishment is audited, however, 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 second part of the series regarding the Comptroller's sales tax alcohol beverage audit program, the author addresses the indirect audit methodologies (e.g., "purchase mark-up" methods) commonly employed by Maryland and most taxing authorities in tax audits (sales tax, meals tax, liquor tax, income tax, business license tax) of alcohol beverage license holders.

Most states typically attempt to directly audit a set of taxpayer records. This normally involves reviewing all fixed asset invoices, and a sample of expensed purchase and sales invoices and register receipts. The auditor will reconcile taxable sales and purchases to those reported on the sales and use tax return for the same periods. For the sampled items, resulting error factors are then projected over the population of expenses and sales.

Given that license holders operating a bar, restaurant or store typically operate on a cash basis, taxpayer records (e.g., register reports, invoices, receipts) may be lacking, incomplete, or inaccurate. If the auditor determines this to be the case, most taxing authorities, including Maryland and the IRS, are authorized to employ other available means to audit the taxpayer. In the case of the alcohol beverage license holders, these methods typically involve use of distributor records to compute a "purchase mark-up," gross sales and related sales tax due, rather than calculating sales tax based on actual sales records. Specifically, the auditor obtains sales records from the taxpayer's distributors, however typically only for a sample period (which implicates all of the potential issues sampling methodologies have, in addition to the potential issues of "purchase mark-up" methods). 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 "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. The auditor's assumptions typically involve consistency in pricing, drink pour size, glass size, spillage, shrinkage, and consistency of inventory and product mix throughout the entire audit period. Needless to say, these assumptions can inaccurately and significantly impact the audit results.

For a license holder facing a "purchase mark-up" audit, the audit method will typically involve a sample period "mark-up," and the projection of the resulting "mark-up" over the audit period's population. Therefore, any inaccurate inflation in the sample period error factor will be projected against the total population, resulting in an exponentially exaggerated inflation of the projected additional tax due. A taxpayer must work with the auditor early during the audit to ensure that the sample period is representative of distributor sales for all other periods. Likewise, once an assessment is issued, the taxpayer must point out the flaws in the auditor's methodology and present reliable evidence of what the proper tax should be. For example, the taxpayer must seek to use a complete, detailed and accurate set of distributor records for the entire audit period, as opposed to a sample. This reduces the need for some of the auditor's "mark-up" assumptions, and increases the likelihood that the results will be statistically valid, reliable and reasonable. Distributor sales records should be verified against the taxpayer's check register and actual invoices, where such records are available. To the extent the auditor utilizes a sample period for purposes of computing the "mark-up," the auditor and taxpayer should agree on the sample periods. If an incomplete set of distributor sales are used, the auditor and taxpayer should conduct statistical analysis to ensure that the distributor sales in the sample period are representative of the other months in the audit period. For example, if one week, one month, or four separate weeks from the audit period are utilized, the audit report should reflect how the periods are representative of all periods in the entire audit period. The analysis should address which days, weeks or periods were selected and why. The analysis should also address whether holidays and seasonality impact sales and product mix, which may

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Terlato Wines Host EXPO Kickoff Dinner

Doug Fletcher, vice president of winemaking for Terlato Wines International was the guest speaker at a special food and wine pairing dinner at Kali's Court & Mezze hosted by Terlato Wines, Reliable Churchill and RAM. The four course dinner featured Terlato wines from Chimney Rock, Sanford, Rutherford Hills and Seven Daughters. The gourmet dinner was well attended and enjoyed by all

Enjoying the evening were Glenn Jaggard; Richard Ackman, maitre d', The King's Contrivance Restaurant, Columbia; Michael O'Hara Stagg and Dale Davis, both from Jordan's Steakhouse, Ellicott City.

Taking a break from the wines and food were (l-r) Peter Frustaci, area manager, Terlato Wines International; Rick Slaughter, vice president of wines, Reliable Churchill; Doug Fletcher, vice president of winemaking, Terlato; Glenn Jaggard, Atlantic region manager, Terlato; Jimmy Smith, CEO, Reliable Churchill; Robert Budke, sales manager, on premise wine division, Reliable Churchill; and Tim Williams, general sales manager, multiple divisions, Reliable Churchill.

Here are (l-r) Peter Frustaci; Glenn Jaggard; Jimmy Smith; Lauren Shipley, director of marketing and special events, RAM; Doug Fletcher; Laura Young, executive assistant, RAM and Dennis Imbesi, director, EXPO and allied membership.

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impact "mark-up" and cause a sample period not to be representative of other periods. The audit should include beginning and ending inventory in computing the taxable sales, rather than assuming that all distributor sales are ultimately sold by the taxpayer.

Taxpayers must also work with the auditor to ensure that any factors affecting the computation of the "mark-up", such as breakage, price and serving size are not based on assumptions, but are all accurately reflected in the computation of the "mark-up." In the next article in this series, the author discusses breakage, and its impact on alcohol beverage license holders. The author also evaluates how breakage may negatively and significantly impact the "purchase mark-up" method audit results and therefore your establishment's potential assessment, should you be audited. Lastly, the author addresses specific measures owners can adopt to address breakage issues during an audit, and improve profitability while doing so.

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