Comptroller's Office Increases Sales Tax Audits; *Part 3 of 5*

What You Must Know

by
Michael T. Dillon, Esq.

As we previously noted in the October and November editions of the Maryland Beverage Journal, the Maryland Comptroller's office has conducted over 100 audits of bars, restaurants, and other alcoholic beverage license holders in the past five years, generating nearly $50 Million in assessments. Under this audit initiative, the Comptroller is utilizing distributor sales data to identify bars, restaurants, and other alcohol beverage license holders for sales tax audits.

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 taxpayers can do to defend themselves before, during and after an audit. In this third part of the series regarding the Comptroller's sales tax alcohol beverage audit program, the author addresses "breakage" – the loss of saleable inventory – and its application in audit methodologies 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.

As previously stated, 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. As any bar/restaurant owner will attest, breakage represents the most significant variable cost of doing business, and can even threaten the viability of the business. When an auditor conducts a sales tax audit using an indirect audit methodology (e.g., "purchase mark-up" methods 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 "mark-up" for the sample period. The sample period "mark-up" is then multiplied by distributor sales for the audit period to calculated estimated gross sales for the audit period. The auditor's assumptions typically include breakage, including whether or not to give the taxpayer any allowance for breakage in estimating gross sales for the audit period. Needless to say, these assumptions can inaccurately and significantly impact the audit results.

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 (4% - 8%). While this is considered to be an industry standard, it is often not reflective of a taxpayer's actual experience. While the Comptroller's auditor may provide an allowance for breakage in estimating a mark-up, they may not allow for breakage for all product types. For example, the Comptroller typically allows for an 8% spillage factor on sales of liquor and wine by bars and restaurants, but no allowance for any breakage on bottled drinks, such as beer. Furthermore, the State typically provides no allowance for breakage by package good stores either. The taxpayer may be able to refute these assumptions, however this typically requires supporting documentation prepared contemporaneous to the audit periods, as opposed to during an audit, or in preparation for the appeal of an audit.

Critical to a fair resolution of the audit, is the taxpayer's cooperation with the auditor to obtain some allowance for breakage on all food and beverage items sold by their establishment, as all of these product types are susceptible to some percentage of breakage. According to 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 is missing over twenty percent (20%) of what it purchases, due to breakage factors. Owners of restaurants and bars are extremely vulnerable to breakage, due to the desirable nature of the inventory that is maintained and the method in which inventory is maintained and sold.

"... making breakage an ongoing issue threatening not only audit results, but also the profitability of the business."

Conscientious owners employ various tactics such as surveillance equipment, bottle collars and pour-measurement methods to identify, quantify, and minimize breakage. However, employees and patrons continually morph their behaviors in response to these methods, making breakage an ongoing issue threatening not only audit results, but also the profitability of the business.

(continued on page 50)

(continued from page 48)

BEVINCO and similar alcohol auditing services enhance these normal modes of theft prevention and breakage detection, by conducting audits of the establishment's sales regularly and without staff knowledge. These audits improve profitability by enabling the owner to identify and minimize breakage by product, and by employee. Furthermore, the results of these detailed reports can be introduced to refute the auditor's breakage assumptions, if any breakage factor was 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 & 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.

In addition to investing in alcohol auditing services, taxpayers should also invest in a relatively sophisticated cash register or point-of-sale (POS) system, one that can provide detailed sales reports and track complimentary sales, spillage, spoilage and other similar factors. Taxpayers should also keep and review weekly records of sales and losses due to breakage factors. Training employees to avoid overpouring and implementing these internal controls should pay for themselves, even if the establishment is not audited.

In the next article in this series, the author discusses other factors, such as pricing, drink pour size, glass size, seasonality, and consistency of inventory and product mix throughout the entire audit period, and its impact on alcohol beverage license holders. The author also evaluates how these factors may negatively 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 these issues during an audit, and improve profitability while doing so.

Michael T. Dillon, Esq. is founder and President of Dillon Tax Consulting, LLC and may be contacted at 410 507-9282 or mike@dillontaxconsulting.com.

MHEF Changes Name to RAMEF

The Maryland Hospitality Education Foundation Board of Directors has changed the organization's name to the Restaurant Association of Maryland Education Foundation (RAMEF). Since 1994 it has been the education arm of the Restaurant Association of Maryland (RAM) and the name change better reflects the partnership between the two organizations.

The Restaurant Association of Maryland Education Foundation will continue to pursue the mission of being the preferred source of education, training, resources and research for Maryland's hospitality and tourism industries. RAMEF offers food safety certifications through the nationally recognized ServSafe program and also offers the Maryland's BEST responsible alcohol service certification. These programs are the backbone of the education that RAMEF provides to those in the hospitality industry, training nearly 3,000 people each year.

"We will continue to serve all aspects of the hospitality and foodservice industry" said Marshall Weston Jr., executive vice president of RAMEF. "Our outreach targets all foodservice operations whether they are hotels, cafés, hospitals, nursing homes, schools, taverns or restaurants."

RAMEF also works toward educating the future workforce through the ProStart program. The ProStart program is a high school culinary and hospitality management curriculum that also requires 400 hours of paid industry work experience in order to receive a ProStart National Certificate of Achievement. Students completing the ProStart program are qualified to enter the workforce in positions that are above entry level and are on a fast track to management careers. There are currently 85 high schools and 2800 students in the program in Maryland.

Paul Hartgen, President and CEO of the Restaurant Association of Maryland stated, "Whether it's ServSafe certifications or the ProStart program, RAMEF helps meet the needs of the Restaurant Association of Maryland's 2500 members and non members alike. This sector has over 9,600 establishments and 170,000 employees. The better educated and more professional we become, the stronger we are as an industry."

More information can be found at www.ramef.org.

RESTAURANT ASSOCIATION MARYLAND EDUCATION FOUNDATION

Jameson and Harford Liquor Stores Raise Funds for Volunteer Fire and Rescue

Jameson Irish Whiskey and 15 Harford County liquor store owners created a fund raiser for the Harford County Volunteer Fire & Rescue group. Funds were generated by Jameson sales from March-June.

Pictured (l-r) at the check presentation are Mike Stine, division manager, Reliable Churchill; Lou Jonske, treasure, Harford County Volunteer Fire & Rescue; Joe Mezzadra, trade development manager, Reliable Churchill; Tony Coliano, trustee, Harford County Volunteer Fire & Rescue; Bruce Richardson, VP, Reliable Churchill; and Bill Dousa, VP, Harford County Volunteer Fire & Rescue.