SCULPTURE HOSPITALITY | EBOOK | SALES TAX AUDIT GUIDE

YOUR GUIDE TO SURVIVING A SALES TAX AUDIT AT YOUR BAR

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sculpture hospitality

Why you'll have to pay sales tax on drinks you didn't sell

If you are unfortunate enough to go through a sales tax audit of your bar operations, you'll be required to pay sales tax on drinks **you never sold**.

If your bartenders stole or gave-away any drinks, you'll be required to **pay extra sales taxes**. And when your bartenders over-pour, which almost all do, you'll be required to **pay extra sales taxes.**

That's because the tax audit process is so **imprecise and arbitrary** that it falsely identifies theft and over-pouring as under-reported sales. In effect, the tax process will conclude that you cheated on your taxes. And as a result, you'll be assessed taxes on drinks you never sold – plus interest and penalties for cheating. Bar owners who honestly reported and paid their sales taxes are facing huge tax bills that threaten to put them out of business.

In this paper, we will explain **how a tax audit works**, then show you how you can **appeal an unfair tax audit and WIN**.

How do they audit bars?

The primary goal of these sales tax audits is to **verify that a restaurant or bar owner is not hiding sales revenues and under-reporting sales tax that they owe**. Each state has different audit rules, but most try to uncover tax cheaters by adding up alcohol purchased in order to estimate the amount the owner probably sold (this is often called a "reverse audit").

Here is how the process works. The tax auditor starts by trying to determine **how many drinks the bar should sell from each bottle**. So if a bar pours a 1.5-ounce shot, then they should be able to sell 22 drinks per liter bottle. The tax auditor then multiplies the number of drinks per bottle by the selling price. So, if the bar with a 1.5 ounce pour size sells Jack Daniels for $5, then every bottle of Jack Daniels purchased should result in revenues of $110 ($5 x 22 drinks).

The state auditor will then **collect invoices for a three-month period to determine how many bottles the establishment has purchased**. It is then a simple manner of multiplying the total number of bottles purchased by the expected revenues per bottle to find out how much tax should have been paid.

Let's make up a simple example where a bar only offers **two brands for sale**, Jack Daniels and Corona. Based on the purchases and selling prices in the table below, the tax authority might project the bar's sales at $63,280. If the bar only reported sales of $53,280, the tax authority would charge them tax on the $10,000 discrepancy.

Example

Brand	Annual Purchases	Sales Expected
Jack Daniels	320 btls	$35,200
Corona	260 cases	$28,080
Total Sales that "**should have been**" reported		**$63,280**

Why the process is a threat to bar owners

This process, however, is **unfair to an honest restaurant owner** for a couple of reasons – starting with the fact that a liter bottle rarely yields the expected number of shots because of "shrinkage". Shrinkage is an industry term for losses due to bartender theft, spillage, and over-pouring. Some states make an allowance for up to 12% shrinkage, while others allow far less.

Unfortunately for bar and restaurant owners, the real shrinkage level is much higher than that allowed by even the most "generous" state or province. In fact, a few years ago the California Restaurant Association asked Sculpture Hospitality to conduct a study of **hundreds of their clients**. Sculpture provides independent inventory control services to clients throughout the world. Since they weigh the bottles/kegs and match up the resulting usage directly to the bar's POS system, Sculpture can **uncover losses to within 1/30th of an ounce**. The resulting Sculpture Hospitality study found that the **average bar loses more than 25% of its inventory due to shrinkage**. Of course that is far more than any state or province allows.

Vanessa De Caria, Sculpture Hospitality's President affirms that **the tax auditing process is seriously flawed**. *"We have over 350 offices around the world and our analysts consistently uncover much higher losses from theft and over-pouring than the tax auditors are acknowledging. Whether we are dealing with a bar owner in downtown Los Angeles or in rural Ohio, our undercover audits consistently find shrinkage of more than 20% - with virtually no exceptions."*

Here's the problem. If the state calculates that the drinks are prepared with a 1.5-ounce portion but the bartenders routinely prepare a 2-ounce drink, the tax auditor will conclude that that the restaurant **underreported their revenues by 25 percent.** As a result, the owner must pay taxes on drinks **he didn't really sell.**

Whether a state allows 12% for shrinkage (California), 8% for shrinkage (Texas) 5% (Ontario), or nothing at all (Washington), if the bartenders are pouring an extra ½ ounce in every drink, the owner will be falsely accused of not reporting all their bar revenues.

The fact is that bartenders routinely over-pour in an effort to garner better tips and they often give drinks away to their friends. These activities are difficult, if not impossible, to detect without the specialized services of a company like Sculpture. **Consequently, the bar owner is penalized twice**. Once when the bartender gives away his inventory and again when the state audit charges him taxes, interest and penalties on this lost money.

David Houston, owner of Q's Billiards in California, says, *"My business was audited by the State Board of Equalization. The state auditor assessed my bar over $100,000 in taxes and penalties that he claimed I did not pay. To say I was shocked would be the ultimate understatement. Their tax assessment could have cost me my business."*

There are lots of other problems with the tax auditing process, including when a spirit brand is sold at different prices in different drinks. For example, a bar might sell a 1.5-ounce shot of premium vodka for $6 but sell the same vodka in a 2.5-ounce martini for $9 ($4/ounce versus $3.60/ounce). If the auditor doesn't account for the fact that the bar calculates less revenue per ounce when martinis are sold then, once again, the owner is getting charged sales tax on revenue that was never collected.

The fact is that he state's auditing process is too simplistic to account for the complexities of drink pricing and portioning in the real-world.

As a result, **almost every bar that goes through a sales tax audit will have to pay extra taxes**. And, although they officially deny it, that is the reason that governments target our industry – because that is where the money is.

I have assisted bar and restaurant owners as an expert witness in **over a dozen appeal**s – all but one of which has resulted in the state entirely abandoning the taxes and penalties.

In this paper, I will **outline some of the precautions you can take now**, before you are audited. Then I will explain the appeal process and detail the strategies we used to win those appeals.

How to audit-proof your bar

I counsel my clients to follow these basic guidelines to avoid tax trouble:

• **Understand that your bar is almost certainly plagued by over-pouring and theft.** Don't assume that if your pour cost looks "good" that your bar is problem-free. Virtually all bars are missing 20% to 30% of their inventory. And because that is far higher than the amount allowed by the tax audit process, the state auditor will conclude that you are underpaying your taxes.

• **Eliminate shrinkage with a good inventory control process.** An effective process will match up alcohol usage to sales so that you can identify and eliminate shrinkage. We offer a range of inventory options at www.sculpturehospitality.com

• The **Audit Manual** that guides California's tax auditors suggests that "**implementing strong internal controls is the best way**" to avoid tax liability problems. They specifically note that "reports from inventory control companies or similar service firms" will be accepted as evidence. When faced with a tax audit, many Sculpture clients have simply handed the state auditor our reports at which point the auditor has closed the case immediately – recognizing that the owner is well-prepared and that their records are likely to be impeccable.

• **Develop detailed recipes for all drinks** sold in the bar and ensure that the bartenders adhere to them

• **Avoid over-pouring by training employees to accurately pour** your specified amounts of alcohol. This is as important for draft beer and wine as for liquor

• **Buy a decent cash register system.** At a minimum, your equipment should be able to separate sales into spirits, wine, and beer categories and also track happy hour and other promotions. If you have a full-blown POS system, you can require the state tax auditor to correctly account for the hundreds of variations on pricing and pour sizes that your POS system can report. This could be invaluable.

• **Track spillage and complimentary drinks.** For comps, sales tax is charged on the wholesale cost instead of the retail selling price. So if you comp a bottle of beer, you are charged sales tax on the $1/bottle cost of the beer rather than the $4 selling price. You are not charged sales tax at all for legitimate spillage. But you'll only benefit if you can document comps and spills so you either need to ring them up into your POS system or you need to have a written spill/comp log.

• **Keep detailed notes on promotions, changes in glassware, spotter's reports, spillage, kitchen use, and so on, for three years**. Most bars do not keep detailed records of promotions and other activities. For example, when a bar has a two-for-one drink promotion or donates a keg of beer to the local fire department, the income loss is usually not recorded. Without supporting documentation, you'll be charged sales tax on this usage – even though you didn't collect any revenue.

What to do if you are audited

• **Realize that the tax auditor is not a bar expert.** They have no particular expertise about bars and restaurants. They have a checklist and a process to follow. If they don't understand something about your business, they will use the rules and assumptions that they have been given by the tax authority or that they have used when auditing a different bar. But these assumptions are often not applicable to your establishment.

You should try to "help" the tax auditor use reasonable assumptions that are applicable to your bar. But you must have credible evidence to support your position.

Draft beer wasted during line clean cleanings is a good example. In some states this waste is not accounted for at all so you need to produce evidence to show how much beer is wasted. Your line cleaning company should be able to provide a written report that you can submit to the sales tax auditor.

• **Be very careful when you fill out the required "Bar Fact Sheet."** The sales tax auditor will give you a form asking you to list pour sizes, pricing, and other information. Make sure that you list all of your pour sizes: for, multiple-ingredient drinks, martinis, margaritas, shots, doubles, drinks prepared "on-the-rocks" and so forth. If your pour sizes are all different, you should make sure that the state takes that into account.

If you changed your beer glassware eighteen months ago, or you extended your happy hour, or if you have a different special every week, include all that information on the Bar Fact Sheet. The more information you give the auditor, the better. You don't want the auditor to oversimplify and end up with a large tax bill as a result. If you have to attach a 30-page sales report, a 20-page list of comps and spills, and numerous notes on glassware changes and specials, do not hesitate to do so. There is no rule that requires you to fit everything onto the simple Bar Fact Sheet.

Once the auditor has made some assumptions and produced a tax assessment, it's difficult to get them to make any changes. You'll need to build a credible case based on concrete evidence and supporting documentation to show that the auditor's assumption is arbitrary or incorrect.

A better approach is to ensure that the tax auditor uses the right information at the very beginning and that starts with the Bar Fact Sheet. Filling it in correctly is so important that you might want to call in some expert help at this point. It is certainly cheaper than having to hire a lawyer and an expert witness in an appeal.

How to appeal

If you are issued an unfair tax assessment, you should fight it. Start by asking the auditor for a copy of the **Audit Manual** that governs the rules and guidelines of the audit process. In California this is a public document.

Hiring an expert witness to assist with the appeal is often a good idea. Try to find someone who understands the tax appeal process as well as the intricacies of bar operations.

In most states/provinces, there are several appeal opportunities. If your appeal is denied at one level, you can escalate it to the next level. In order, the levels are:

1) Appeal to Auditor

Most auditors will issue a preliminary audit report for you to review. You should use this opportunity to point out any factual errors, mis-calculations and any incorrect assumptions. If you have a good relationship with the auditor, you can often get basic mistakes fixed.

2) Appeal to Supervisor

When you have been issued a final tax assessment, you have the opportunity to formally appeal it. The first level of appeal is a meeting with the Auditor and their Supervisor. I haven't had very much success at this level of appeal. Usually the Supervisor just defends their Auditor, no matter how illogical their position may be. I believe this is because the Supervisor only has very limited powers to make changes to an audit.

3) Appeal to District Manager

This is the appeal level at which I have had all my success. The District Manager has broad authority to change the audits. You'll need to provide convincing evidence but, in my experience, you will get a good opportunity to make your case to a reasonable person.

4) Appeal to Board of Directors

If you haven't succeeded the District Manager appeal, things get much more difficult at the Board level. The challenge here is that you are given an extremely tight time limit in which to make your case. The Board meets infrequently and has to hear a lot of cases in a small amount of time so they rush things along. In California at least, they tend to side with the tax authority over the taxpayer.

5) File a Lawsuit

Well established case law allows the government to use their audit process, no matter how questionable, to assess additional taxes. So it is unlikely that you will be able to challenge the validity of the process itself. You'll need to find a legal basis to identify specific assumptions for which the auditor did not follow the tax authority's guidelines and rules. The big problem with a legal challenge is that it is extraordinarily costly. A tax lawyer typically costs $500+ per hour.

Basis of appeal

Pour Sizes

Believe it or not, sometimes the auditor doesn't even account for your normal pour size correctly in their calculations. A few years ago I was an expert witness for an owner who set his standard pour at 2 ounces. But the state auditor only allowed 1-½ ounces and told us that California law **did not allow for a larger pour size**. In our appeal we pointed out that the auditors contention was nonsense – California does not have pour size restrictions. We then quoted section 0806.05 of the state's sales tax audit manual which explicitly states that the auditor can accept a larger pour size as long as it is *"supported by detailed audit comments and/or documentation such as the performance of an average pour test or an undercover pour test."*

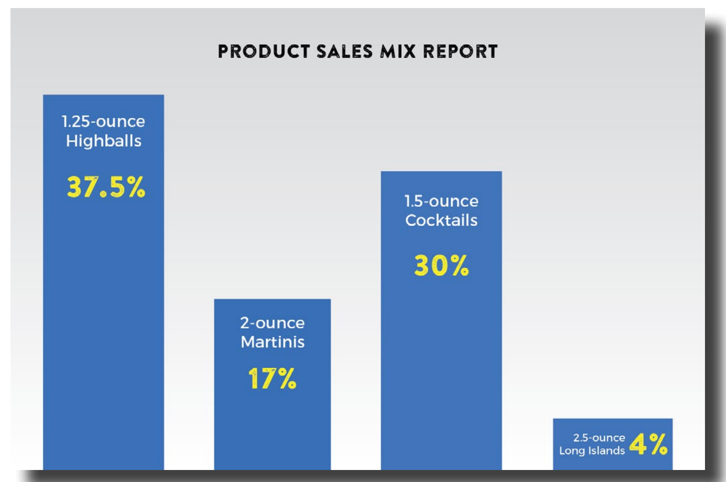
Even when the auditor gets the pour size right, they tend to over-simplify by assuming that there is one single pour size for liquor, another for wine and perhaps two for draft beer (mugs and pitchers). Of course most bars are much more complex than that. There might be a pour size for a 1.25 ounce pour for a vodka and tonic, 1.5 ounces for a White Russian, 1.75 ounces for a vodka poured on the rocks, 2.5 ounces for a martini – and many more pour sizes for Long Islands, doubles, shots, etc.

In almost every appeal, when we submitted evidence of this complexity, the tax assessment dropped significantly.

Sales Ratios

In most appeals, we also prove that the auditor has incorrectly estimated the sales ratios of various types of drinks. Usually it is because of another gross over-simplification where the auditor might have concluded that ¾ of the sales are for 1.25-ounce highballs and ¼ of the sales are for 1.5-ounce cocktails.

If those sales assumptions are incorrect, it can have a big impact on the tax calculations. In most appeals, we submit a detailed product sales mix report, often running to 30-pages, to support our own calculations that, say, 37% of the sales are 1.25-ounce highballs, 17% of the sales are 2-ounce martinis, 30% are 1.5-ounce cocktails, 4% are 2.5-ounce Long Islands, etc., - along with the average pricing for each category.



In addition, we would point out where the Sales Report also shows that **happy hour sales and doubles are also a larger proportion** than accounted for in the audit.

Our goal is to prove that the bar sold a higher proportion of drinks selling for a lower price per ounce, which can have a dramatic impact on the tax projections.

Modifiers

We make a similar argument whenever the audit has insufficiently accounted for **sales of modifier keys**. And in my experience, the modifiers have been completely ignored by the tax auditor almost **every time**.

It might help to provide an example of how this can lead to a higher estimate of sales tax. Let's say a bar with a 1-½ ounce pour size sold one "Double Crown Royal" for $10 and it was rung up as a "Crown Royal" then modified with the "Double" key. When the tax auditor ignores the impact of the double modifier key, the process would simply calculate that 3 ounces of Crown Royal were used and, therefore, that two drinks were sold. If Crown Royal sells for $6, the tax audit would conclude that the bar collected $12 in revenue. But, in this example the sales were only $10. Thus the state incorrectly calculates that you under-reported tax on $2 in sales

The same is true when a bar has a "rocks" or "neat" modifier key with a small upcharge to account for an extra-large portion on those drinks.

When preparing an appeal for a client, I always **calculate the impact of the modifier keys** and incorporate that analysis into our petition.

Non-Sales Brands

Because most auditors do not understand the bar business, they almost **always extrapolate usage of non-sales** brands into revenue. In most appeals, I make the argument that some brands do not usually generate any revenue. Many times I have seen the tax auditor calculate that because the bar purchased 100 bottles of triple sec or blue curacao, that usage would convert into almost $9,000 in sales revenue based on 2,200 drinks sold @ $4.

In reality, of course, **customers almost never order triple sec or blue curacao or vermouth** and usage of those types of brands is just a cost of pouring a drink, like adding a wedge of lime, not a source of sales. The same is true of sparkling wine used for bottomless mimosas on a weekend brunch menu.

Draft Beer Losses

All bar owners know that **draft beer generates waste from system issues, poor pouring techniques and required maintenance**. In some states/provinces, the audit process explicitly recognizes this. For example, California's audit manual states that "a taxpayer with numerous beer lines and/or beer lines in excess of the average length (approximately ten feet) may claim that the draft loss is greater than the 10% standard over-pour and spillage allowance. An adjustment for additional loss may be provided when the claim is documented and supported by evidence (e.g., invoices on the number, length, and diameter of beer lines, frequency of line cleaning, etc.)"

There are two appeals I almost always recommend. **First**, we submit evidence from a draft beer line cleaning company documenting the length of the draft lines, the amount of beer wasted every time the lines are cleaned, and how often that occurs. For example, a bar with 10 taps that are located 100 feet from the cooler would be able to document that almost 50 pints of beer are wasted during each of the 26 line cleanings per year. The appeal should request credit on the resulting 1,300 pints of beer that were used but did not generate any revenue.

Second, we submit evidence that, say, 4 pints of beer are wasted whenever a keg is blown and needs to be changed If there are 10 keg changes every week that translates to 520 blown kegs and over 2000 pints every year.

Spills/Comps

When you submit evidence of spillage no sales tax is owed. When complimentary drinks are documented, most states/provinces calculate sales tax at the wholesale cost, not the retail selling price.

So if the sales tax is 10%, then 60¢ in due for sales tax every time a $6 Crown Royal is sold. But if a Crown Royal is comped the 10% tax is due only on the $1 cost of the comped drink. So in this example, that would mean a tax of 10¢ on a complimentary drink versus a 60¢ tax on a regular sale.

Theft

Almost all bars experience some amount of outright theft. Unfortunately, the tax audit process **will not recognize theft** unless you can document it with "police reports, reports from regularly employed private security guards, private detective agencies, insurance claims, reports from inventory control companies or similar service firms" (from California tax audit manual). This is almost impossible. Even if you could say for certain that a bartender collected money from a customer but did not ring it up, good luck trying to file a police report.

In fact I am currently working for a bar owner who submitted two dozen sworn affidavits from customers and bartenders attesting to theft – and the **tax authority will not even accept that as evidence of theft.**

It gets worse. If by some miracle you are able to convince the tax authority that there has been theft in your bar, **you'll still be expected to pay sales tax on the theft.** That is because the government makes a distinction between theft of inventory, which is non-taxable, and theft of cash, which is taxable. When a bartender sells a drink to a customer, collects the money but puts it in the tip jar instead of ringing the drink up, the tax authority decrees that the bartender has stolen the cash, not the drink. Their position is that if you sell something, you pay sales tax on it, regardless of whether someone subsequently steals the cash proceeds.

The state's position is irrational and unfair. But the fact remains that when your bartender doesn't ring up a drink, you still owe sales tax.

The only time you don't owe sales tax on theft is when you can prove that someone stole product by physically walking out of the bar with it.

The tax authority will not treat you fairly if you ask for tax relief for theft – in fact, it will bolster their position that you under-reported taxable sales! The tax auditor is well aware of this and, in many cases, will try to manipulate you into admitting that some of the discrepancy between reported sales and the tax audit calculations is due to theft.

I counsel my clients that we should concentrate on appealing only those issues for which we have both clear evidence and a reasonable expectation that the tax authority will give our appeal due consideration. Since neither of those factors is likely with respect to theft, we do not use theft as part of an appeal. Furthermore, if asked we never concede that the tax assessment could be impacted by theft (suggested response: *"we don't have specific evidence about theft – we do have evidence that alcohol was used but not sold"*)

Over-Pouring

Every bar is plagued by over-pouring, whether they know it or not. Tax authorities make varying allowances for this, ranging from zero in Washington State, to 5% in Ontario, 8% in Texas and 12% in California. Since all of these are far below the 20+% average shrinkage in most bars, this is a problem for honest bar owners.

Because it is such a **big problem** it is also critical that you address over-pouring in an appeal.

At the risk of sounding self-serving, the best thing to do is to contact an independent alcohol auditor. If you call our company (1-888-BEVINCO) for example, we'll put you in touch with one of our 400 offices. When you meet with our analyst, we will recommend that we run a two-week **Discovery Period in your bar operations**. During the Discovery Period, our team will do three inventories at your bar to measure the variance between what was rung up and what was poured. **Our inventory process is extremely precise**: we actually weigh every open bottle of liquor and wine and every tapped keg, as well as counting the full bottles and accounting for purchases. Then we match up that usage to the POS or cash register records for each type of drink sold.

bevinco
Hospitality Control Services

April 23-29

	Ounces Used	Ounces Sold	Ounces Missing	%Over or Short
Crown Royal	8.04	6.25		
Seagrams VO	14.93	13.75		
Bushmills	1.43		-1.43	-100.0%
Dalwhinnie	1.96	1.50	-0.46	-23.5%
Glenfiddich	2.05	1.50	-0.55	-26.8%

▶ Nothing Sold (theft?)

▶ Over-pouring!

Through this process we can **determine exactly how much over-pouring and other shrinkage** is occurring in your bar (obviously it is imperative that your managers and staff don't know that we are doing these inventories because we want to measure the real shrinkage for use in a tax appeal).

A Discovery Period is **always my first step in an appeal process** because it arms the bar owner with unimpeachable data from an independent third-party. We submit the inventory variance reports in a sales tax appeal in order to prove the exact amount of shrinkage that should not be subject to sales tax.

By weighing bottles and matching up the usage from each brand to the sales in the POS system, the process is **almost impossible for the tax auditor to refute** – especially when we compare our process to the crude and imprecise process that the tax auditors employ.

Penalties

Always appeal the penalties. In my experience the auditors always apply a penalty when they calculate a tax assessment. But, in most jurisdictions, a penalty should only be applied when there is *"evidence that any part of the tax deficiency is the result of negligence or intentional disregard of the law or authorized rules and regulations."*

So far we have been able to convince the tax authority to eliminate the penalties every time.

Settlement offer

We've been successful in eliminating the entire tax assessment, penalties and interest in most of the cases in which I've been involved. In a couple we were able to get the tax assessment reduced, but not eliminated. In those cases, my client made a settlement offer. For example, if their tax assessment had been **reduced from $60,000 to $18,000**, my client offered to settle the case with an immediate payment of $10,000.

Most states/provinces will entertain settlement offers. If you make the offer in good faith, there is a pretty good chance you'll get a counter-offer.

Help

If you need help with a tax appeal, or if you decide that it makes financial sense to **eliminate theft and over-pouring** even if you are not being audited, let us know. One of our experts will meet with you to explore whether or not we'll be able to help. No obligations and no sales pressure. You can reach us at **www.sculpturehospitality.com** or you can call me at **(619) 630-8231**.

About the Author: Ian Foster joined Sculpture Hospitality in 1991, and has spent the past two decades helping his clients eliminate over-pouring, mis-ringing and theft from their bar operations.

He has written extensively about improving bar profitability for industry publications such as Santé magazine, The Publican, numerous restaurant association publications from coast-to-coast as well as Robert Plotkin's Bar Profits newsletter. Ian is also the publisher of Sculpture's Booz Nooz.

Together Ian and the California Restaurant Association (CRA) successfully fought to change California's sales tax laws which the CRA estimates will result in "yearly savings of $3 million to $4 million dollars for CRA members"

Converse with him on LinkedIn

*Disclaimer: Please contact your local attorney for your own independent legal counsel and advice