



Tax Audits Threaten Bar and Restaurant Owners

-by Ian Foster

Most taxpayers fear a visit from an Internal Revenue Service but at least they are guaranteed a fair hearing. Bar and restaurant owners face an even more menacing threat in the form of a state tax investigation. These revenue and tax audits are the state's way of ensuring that all businesses pay their fair share of taxes. More and more operators, however, are complaining that a state tax audit is not merely an inconvenience but is actually unfair even to the most honest proprietors.

About half the tax audits across all industries prove that the owner did indeed remit the correct amount of sales tax. Yet, in the restaurant industry almost a third found that more tax was due, according to state records. In Texas, for example, the average assessment was for more than \$15,000, *not including* penalties and interest. And some owners have seen their whole business threatened because the state says they owe hundreds of thousands of dollars more tax than they reported.

David Houston, owner of Q's Billiards in California, says, "My business was recently 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. This finding could cost me my business."

Why do so many bar owners feel that the process is unfair?

The primary goal of these tax audits is to verify that the estimated revenues match the amount reported to the state. Each state has different rules, but usually a state tax auditor will use the amount of alcohol purchased by a bar to calculate how much the owner probably sold (hence they are often called "reverse audits"). This result is then compared to the amount actually remitted by the bar to see if the owner underreported revenues and taxes.

The taxable revenue is usually estimated by figuring out how many shots the bar can pour from each bottle and then multiplying this by the selling price per shot. For example, if a bar pours a 1½ oz shot, then they should be able to sell 22 shots per liter bottle (1.5 x 33.8oz). If each shot sells for \$3, then every bottle that the bar purchases should result in revenues of \$66.

The state auditor will then examine invoices to determine how many bottles the bar has actually purchased. (That is the primary reason why many states require liquor retailers to purchase only from state stores or from licensed liquor distributors). It is then a simple matter of multiplying the total number of bottles purchased by the revenue expected per bottle to find out how much the state thinks the bar's revenues should have been. Similar methods are used to audit other industries as well.

This process, however, is a nightmare even for the majority of bar/restaurant owners who honestly report their taxes each year because of the unique nature of the bar business. Four issues in particular cast doubt on the way that the state tax boards calculate expected revenues.

By far the biggest problem is that the state does not adequately take shrinkage into account. Shrinkage is an industry term for the losses incurred from internal theft, spillage, and over-pouring by bartenders. Texas only allows 1/10th of an ounce on shots of liquor (about eight percent) and up to 10% on draft. California allows 8% shrinkage on liquor and nothing at all for draft beer. (The California State Board of Equalization says that the eight percent allowance is based on a liquor industry study that is more than thirty years old and unavailable for review).

"For most of these establishments, the shrinkage level is much more than eight or ten percent," says Marc Weinberg, New Jersey franchisee for BEVINCO, an independent beverage inventory control service. "In my years at BEVINCO, I've seen liquor shrinkage losses averaging 20 to 30 percent, and seen a fair number of bars with liquor losses exceeding 50 percent. The highest amount subtracted for shrinkage by the state is ten percent, and therein lies a real problem."

BEVINCO has conducted thousands of audits for bar owners throughout the country over the past twelve years. Their investigators have determined that the average shrinkage is actually 23 percent on liquor and draft, about 10 percent on wine and 2 percent on bottled beer. BEVINCO auditors employ a laptop computer and a set of scientific scales to

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match up usage with sales to uncover these hidden losses – in fact BEVINCO can uncover losses as small as 1/100th of an ounce.

Barry Driedger, founder and president of BEVINCO (www.bevinco.com), affirms that the tax auditing process is seriously flawed. “We have over 100 franchised offices throughout North America and our auditors consistently uncover much higher losses from theft and over-pouring than the state 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 percent - with virtually no exceptions.”

The state is in effect penalizing innocent bar owners twice. First the bar owner loses one in five drinks to internal theft and then the state charges him taxes and penalties on this lost money.

The state tax authorities claim that they can make additional allowances if the taxpayer can document additional levels of shrinkage but they generally expect a police report. This may work well for retail businesses such as department stores but it is virtually impossible for the hospitality industry. Bartenders giving away drinks to friends or overpouring in an effort to garner better tips cause almost all the shrinkage in a bar. These activities are difficult to detect without the specialized services of a company like BEVINCO and, consequently, they almost never result in police action.

The second major problem with the state’s analysis is that it is based on a mark-up factor calculated for each product. The methodology used is inaccurate because most brands are sold at different prices and even in differing quantities, depending on the cocktail sold. For example, many bars sell their regular vodka for \$3 per shot and expect to sell 27 shots per bottle. This would result in \$72 of taxable revenue per bottle. However, the same vodka is also sold as a Screwdriver for \$3.25 - which would yield \$87.75. Finally if the very same vodka is sold in a Martini (with a 2.5oz pour size), then it would yield \$4 x 13.5 shots = \$54. This means that the state could calculate taxable revenue of anywhere from \$54 and \$87.75 depending on how they decide to value the vodka.

In fact, the expected revenue per bottle can vary by as much as 60 percent depending on which assumptions are made. This enormous range raises serious concerns about the arbitrary and unreliable nature of the tax audit; especially considering that a state tax audit could be the difference between profitability and bankruptcy.

The third shortcoming of a tax audit is that most bars see their sales mix fluctuate continuously. For example, Happy Hour sales might represent 20 percent of revenues one month and 25 percent the next. Because the state auditors look at purchases to determine tax liability, a bar offering a two for one Happy Hour and experiencing a similar small change in Happy Hour sales would pay a big price. If they had sales of \$100,000 per month, such a bar could face a tax bill on \$7,500 in revenue that they did not sell.

The variety in sales mix means that most bars see similar swings in their sales between cheaper brands and premium ones; domestic to imported beer; and even wine sales compared to liquor. Each of these products has a different profit margin and each change can affect the taxable sales that a bar earns. To combat this, the state auditors use all the purchases for a "representative period" to calculate a mark-up factor. However because the sales mix can vary not only daily but monthly and even seasonally, bar owners should insist that multiple periods can be sampled – at the very least, a sample week from each quarter would be more equitable.

Another concern is that a bar is primarily a cash business and most do not keep detailed records of promotions and other activities. For example, when a bar has a two for the price of one drink promotion or donates a keg of beer to the local fire department, the income loss is usually not recorded. Without supporting documentation, the usage on these items will be converted to potential retail sales and taxed.

Tips for Bar Owners

“You can’t avoid a sales tax audit because it is becoming a mandatory law in most states,” Weinberg says, “but you can take some precautions to avoid a costly situation.” He offers these prevention tips to bar and restaurant owners on protecting themselves:

- 1) As soon as a bar owner is informed of a pending tax audit, they should hire an independent auditing company like BEVINCO to find out the bar’s REAL shrinkage rate. This could be invaluable in proving to the tax auditor that their shrinkage allowances are too low for their bar

Charles Deibel, a BEVINCO owner in Ohio says, “I had a client whose shrinkage was above thirty percent due to employee theft, and in Ohio, the amount subtracted for shrinkage is only two percent. Because this establishment had a BEVINCO report explaining their level of shrinkage, it saved \$10,000 and was able to remain in business;”

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Who is BEVINCO?

BEVINCO is an international liquor auditing service. We work for thousands of bar and restaurant owners throughout North America. Your BEVINCO auditor uses a computerized program to weigh every container of liquor, wine and beer in your bar.

Our weekly reports will then compare the usage and the sales of every drop of alcohol in your bar. BEVINCO will uncover hidden losses and give you the tool needed to eliminate any theft, over-pouring and bartender sloppiness.

BEVINCO has found that the average bar and restaurant is missing over 20%.

We have over 160 offices throughout the world. We will be happy to send you more information on our service. One of our auditors and consultants will give you a free demonstration, please call us anytime at:

1-888-BEVINCO



Joe Franchisee, BEVINCO Big City
One of 10 BEVINCO auditors in your area

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- 2) Find a qualified representative. Most states will consider evidence to support taxpayer concerns. Selwyn Yoslowitz, co-owner of the Marmalade Café in California, was able to submit BEVINCO reports that supported his claim that his shrinkage was much greater than the state was allowing. This resulted in a favorable tax ruling that saved the restaurant significant tax penalties.
- 3) Buy a decent cash register or P.O.S. system. Texas law requires at least three keys separating liquor, wine and beer, but a separation of Happy Hour and other promotions is also an absolute necessity. In fact, the more detailed the sales report, the better an owner is able to provide evidence that the tax auditor will accept;
- 4) Keep all paperwork, including detailed notes on promotions, changes in glassware, spotter's reports, etc., for three years. The state auditor will consider all your evidence. In fact, in California, if the state auditor finds that additional tax is due because of inadequate record-keeping, the owner will be charged a 10 percent negligence penalty;
- 5) Keep weekly records of all complimentary sales, spillage and items removed for cooking and other purposes (i.e. brandy used in food recipes). Add a distinctively identified component to your weekly sales tax deposits, representing the sales tax on the wholesale value (i.e. the price you paid) for those items. It's far better to pay a small sales tax now than to pay a much larger (often seven or eight times larger) tax later on the "estimated resale value" of those items (And that's before even considering penalties and interest);
- 6) Develop detailed recipes for all drinks sold in the bar and ensure that the bartenders adhere to them;
- 7) Avoid "overpouring" by training employees to accurately pour your specified amounts of alcohol. This is as important for draft beer and wine as much as for liquor; and
- 8) The California State Board of Equalization suggests that "implementing strong internal controls is the best way" to avoid tax liability problems. Effective inventory controls, such as BEVINCO's service, pay for themselves even if a bar is not audited.

Ian Foster is an independent auditor for BEVINCO, an alcohol auditing service for bar and restaurant owners. He can be reached at 1-888-329-7884.



“This finding could cost me my business”

This *special issue* of the Booz Nooz is dedicated to an urgent issue that threatens bar and restaurant owners throughout the country: **a tax audit by the state board.**

In response to urgent requests from our clients, we researched the whole issue of tax audits. We were shocked to find that the state’s tax auditing process is fundamentally flawed. Even honest operators can see their livelihood threatened by an incorrect and unfair tax assessment.

Every owner has to be aware of the financial implications of a tax audit. The article that begins on page one analyzes the problem. On pages 2 and 3 we have outlined eight tips that can help you minimize or eliminate the damage to your business.

For more information or a free consultation, contact BEVINCO at 1-888-238-4626.



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