

SPECIAL MIXED BEVERAGE TAX SEMINAR

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SAN ANTONIO HOTEL & LODGING ASSOCIATION

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OUR SPECIAL THANKS TO JUSTIN HOLLEY, GENERAL MANAGER FOR WYNDHAM GARDEN RIVERWALK HOTEL AND TO CARYN HASSLOCHER, OWNER FRESH HORIZONS CATERING

An Open Letter to All Mixed Beverage Permit Holders in the State of Texas

Beginning October 1, 2012ⁱ, Audit Division of the Comptroller's Office very quietly and without notice changed their policy related to Mixed Beverage audits. The policy change almost guarantees that if you are selected for audit, you will be assessed a liability.

No matter how good the records, internal controls or adherence to the law, any Mixed Beverage audit is by its very nature an estimation. Since the inception of the tax in the 1970's, the estimation procedure has employed the depletion methodology. In recognition that any estimation is imperfect, first the TABC and more recently the Audit Division of the Comptroller's Office used to compare what the taxpayer reported to the amount they estimated the taxpayer "should have" reported. If a taxpayer with good records had reported within 7.5% of what the auditor estimated, no liability was assessed. If the taxpayer had bad records, the "close enough" amount was 5%. This was referred to as the error rate variance policyⁱⁱ.

The new policy does away with looking at error rates. Now, if the calculated tax due is over the auditor's materiality threshold (most likely, \$2,000.00), tax will be assessed. After they calculate your tax due, they will give the taxpayer a 5% allowance off the assessment. That 5% allowance is not new. They already do that.

Why will an assessment most likely be made? There are several important variables which determine the calculation of tax due in the depletion analysis. The pour size of distilled spirits drinks, properly identifying the secondary liquors, properly identifying and proving wine and or beer used in cooking, the quality of recordkeeping, the glass sizes, wine pour sizes, the range of prices of wine, the calculation of average sales prices of drinks by category (distilled spirits, beer, and wine) all have to be determined with a degree of specificity that is not always exactly accurate. One does not have to be off much in order to get over the \$2,000.00 tax due threshold. And remember, the burden of proof is on the taxpayer. An audit has nothing to do with what actually happened. It has everything to do with what the taxpayer can prove happened.

Who will be affected the most? It is truly ironic that this new policy will eventually flip who is selected for audit. Under the error rate policy, the largest reporters of tax were the least likely to produce a tax due audit – namely, large hotels and large restaurant chains. This was because those entities were the most likely to have the best internal controls, the most stable employees, the most complete records, and the most oversight in order to quickly identify and resolve problems. Given the leeway that was afforded in the past, it was not as critical to get every variable exactly right in order to get a no tax due audit. But under the new policy, all those variables listed above (and that list is not all inclusive) better be exactly right, or you will be assessed. For perspective, consider the following: If you reported \$3,000,000.00 in tax over the four year audit period, a 1% error would produce a \$28,500.00 liability (30,000.00 less 5% allowance). A 7.5% error would translate to \$213,750.00 in tax due (225,000.00 less 5% allowance). Keep in mind these variances can easily be due to auditor error, not anything that was done by the taxpayer. In the past, both these audits would have been no tax due. With numbers like

that, it is predictable that smaller but non-compliant taxpayers whom the state used to be concerned with will be less concerning. So the answer to the question posed at the beginning of this paragraph is the good corporate taxpayers will be audited more and the smaller, more difficult but less compliant taxpayers will get audited less. Do the math.

Why did Audit Division change their policy? In 2011, a judge in a State Office of Administrative Hearings (SOAH) ruled that Audit Divisions policy was not a policy, but a “discretionary management tool”ⁱⁱⁱ. Two huge problems exist with this statement. One, the statement is demonstrably false. Two, the SOAH petitioner did not challenge the ruling made by the judge. Once the petitioner failed to challenge the ruling, Audit Division changed their policy to match what the judge ruled. They knew this meant a lot of revenue would now flow to the state from Mixed Beverage permit holders.

Is this legal? That is a good question, and I am not sure about the answer. Clearly, the Comptroller has to be able to audit Mixed Beverage taxpayers, and no matter how that is done the audit will be an estimation. However, Administrative Procedures Act (APA) guidelines are supposed to be followed when the agency adopts rules that affect people’s taxes. The depletion methodology has been in use for years and hearings have upheld the agency’s right to use it. However, the depletion spreadsheet was never adopted through the APA procedures. The use of the depletion spreadsheets up until now had the built in error rate benchmarks that required auditors to “no tax due” or NTD audits falling into an acceptable range just to keep things fair. Removing the range absolutely changes the dynamics of the equation. The agency is ascribing a level of precision to the depletion methodology now that simply does not exist. One thing that is for sure is that they (Audit Division) did this. And they will continue to do it unless they are challenged. In this author’s view, when Audit Division went away from the error rate variance policy in favor of a materiality policy, they completely circumvented the Legislative process. They changed their own job description from being in charge of tax compliance to being in charge of revenue generation!

What should Mixed Beverage taxpayers do about this? Strength is in numbers. Mixed Beverage taxpayers as a group needs to lobby the legislature to adopt the depletion analysis going through the APA guidelines. Ask for input into its creation and adoption. Lobby the legislature to include the error rate factors. Get an audience with the new Comptroller after Susan Combs leaves office next year. Most important, get competent help if you are notified that you will be audited.

ⁱ See email from Emma Fuentes from the State Comptroller’s Office.

ⁱⁱ See Audit Manual and Common Errors in Mixed Beverage

ⁱⁱⁱ See SOAH Hearing 104,344

A Practical Guide to HB 3572

The 83rd Legislative Session passed House Bill 3572, which impacts all Mixed Beverage Tax permit holders in the state. It increases the overall tax rate paid to the state to 14.95%. The law takes effect beginning on January 1, 2014. This law does the following things:

- 1) It reduces the Mixed Beverage Gross Receipts Tax rate from the current 14% to 6.7%.
- 2) It creates a new tax known as the Mixed Beverage Sales Tax (MBST). The rate of this tax is 8.25%. However, this tax is NOT the same as the current Sales Tax and needs to be accounted for and reported separately.
- 3) You will need to choose how to account and report this new tax: Tax Included or Separate line item showing the tax.
- 4) It increases your reporting responsibilities.
- 5) It increases your documentation responsibilities.

Decision #1 – Tax Included or Separate Line Item?

The first decision that needs to be made by each mixed beverage permit holder is: Am I going to account and report for the new tax by declaring tax is included in the sales price or am I going to account for the tax separately? The state will allow either procedure. Your individual accounting systems (POS systems or manual cash registers) may dictate your ultimate choice. The state is assuming most bars will choose to report tax included as bars like to deal in round numbers. They assume the rest of the population will account and report the new tax as a separate line item. An example will help clarify the difference between the two methods.

Tax Included

In this example, let's assume I sell a margarita for \$5.00, tax included. The first thing I must do is let my customer know on his receipt that MBST is included in the \$5.00 charge he is seeing. Next, when I report this to the state, I would show the following:

On the Mixed Beverage Gross Receipts Tax monthly Report, I would report:

Gross Sales: $5.00/1.0825 = 4.62$

Mixed Beverage Gross Receipts Tax = $4.62 * .067 = .31$ Gross Receipts Tax

On the Mixed Beverage Sales Tax Return, I would report:

$\$4.62 * .0825 = .38$ Mixed Beverage Sales Tax

Note that the .38 cents calculated in this manner equals the $5.00 - 4.62 = .38$

Finally, on the monthly Sales and Use Tax Report, this transaction would show up as 4.62 in Gross Sales, but would not show up in taxable sales at all.

Separate Line Item

Now let's assume I sell that same margarita in a system where I separately account and report the mixed beverage sales tax separately. The first thing is on the receipt I give my customer, it will say

Margarita \$5.00

MBST .41

Total \$5.41

When I report this sale to the state, the Mixed Beverage Gross Receipts Tax would be as follows:

Gross Sales: \$5.00

Mixed Beverage Gross Receipts Tax = $\$5.00 * .067 = .34$

On the Mixed Beverage Sales Tax Return I will report:

Sales = \$5.00

MBST = $\$5.00 * .0825 = .41$

Note this matches what my customer got on his receipt

On the monthly Sales and Use Tax Return, the transaction would show up as \$5.00 in Gross Sales and zero in taxable sales.

Summary

To summarize, here is what you need to know about HB3572. It lowers the Mixed Beverage Gross Receipts Tax Rate from 14% to 6.7%. It creates a new tax, the Mixed Beverage Sales Tax, and that tax rate is 8.25%. This tax is different from sales tax and needs to be accounted for and reported separately. Mixed Beverage permit holders need to make a decision as to how they account for the new tax: either tax included or separately stated. The receipts given customers need to reflect this decision. The documentation and reporting requirements become greater under the new law.

The 4 “P’s” of a Mixed Beverage Audit

I like analogies, and the first analogy that came to my mind about MB audits was that of a professional boxing match for a lot of reasons. Both are adversarial in nature, they can be brutal, and you never want to walk into the ring unprepared. The referee’s final admonition before a fight is certainly true before an audit: Gentlemen, protect your selves at all times!

How do you protect yourself in an audit? Understanding the 4 “P’s” of Mixed Beverage is a good place to start. The four P’s are: Price, Pour, Purchase, and Proof. The result of your audit will depend on these 4 elements.

Price: The average sales price of distilled spirits, wine and beer is very important. It is critical to a fair audit that the average sales prices get calculated correctly. In some cases, this is a straight forward matter. POS systems certainly make calculations easier if you have a POS system. But even if the auditor has to look at cash register tapes, he is required to do so. Auditors frequently overstate the average selling price of a drink category and thereby overestimate the amount of tax due in an audit. If you get audited, make sure the auditor gets this right.

Pour: The pour can relate to the size of drink glasses or pitchers, but also relates to the amount of distilled spirits poured into each drink. This element causes more grief and misunderstanding than anything else, and can be very costly if it is understated by the auditor. Many bartenders will be afraid to pour the amount of liquor they really pour during the pour test. They may be afraid TABC will be alerted or the owner will be upset at them. Well, honesty is the best policy. If you usually pour 2 ounces in a drink, then state that and show that during the pour test. Understate the pour, overstate the tax liability due.

Purchases: The state now has access to your alcohol purchase records, and they rely on that data. But guess what. Reported amounts are sometimes wrong. This past week I was working on an audit where a vendor reported selling \$13,000.00 in alcohol to my client when in fact they had sold \$288.00 to my client. That would relate to about \$7,200.00 the state would assess in tax that is clearly not due. Make sure what the state says you bought you did in fact buy.

Proof: It is unfortunate but true that an audit has nothing to do with what happened during the audit period...it has everything to do with what you can *prove* happened during the audit period. Without adequate documentation, auditors are left to their own devices to arrive at a tax liability. Many bar owners are good at what they do, but not so good at keeping records. Keeping good records will not only help you in an audit situation, but will also help your business in the long run.

A mixed beverage audit hinges on these few items. Getting the elements right, especially when documentation leaves something to be desired is both a science and an art. If you need help, call us. We have the best scientists and artists around.

So You Are Being Audited

You just got notification that you are under audit for sales and use tax. Unless you have been through the process before, you probably have a lot of questions about why you are being audited and what the audit process is like. This paper attempts to answer some of these questions.

Why am I being audited? Do they think I did something wrong? There are several main reasons your business has been selected for audit. You may have been selected because of the size of your reported receipts. In general, the state considers the more receipts you are reporting the larger is their potential exposure. This is perhaps the single biggest driving factor in who is selected for audit. Another common reason is bad luck. Your tax identification was selected at random. Another similar reason is that the state is focusing in on your particular industry and once again, your number randomly came up.

You may have been chosen because your reporting history seems “funny”. For example, I was given an audit of an establishment that was classified as a “retail” store according to their NAICS code. They were reporting only 5% of their sales as taxable. Clearly, that seems funny. When I arrived, the establishment was a tattoo parlor which is a personal service that is not taxable. They were correctly collecting and remitting tax on the sale of tangible personal property (TPP) such as ear and nose rings, studs, etc. Errors in the NAICS code cause many needless audits.

You may have been selected for audit because someone has reported your business as an audit lead. Many audit leads are legitimate, and many are illegitimate. And finally, the worst reason for audit is that you were previously audited and had a liability in excess of \$10,000.00. If you had a prior tax due audit of this size, it is a sure thing that the state will be back.

Regardless of the reason, let’s assume you have been selected for audit. What will the process be like? What is the state checking for? Speaking in the broadest of terms, there are two places that lead to audit liabilities: taxability errors and reporting errors. And breaking that down a bit further, taxability errors occur on the sales and purchase sides. Sales taxability errors usually occur due to the complexity or misunderstanding of the law. For example, a convenience store is getting audited. The state sets up tax on the sales of flavored Perrier water. The store owner says: “Wait, water isn’t taxable!” Well, that is true. Water isn’t taxable. However, when flavoring is added to water, the state views that product as a soda. So the unflavored Perrier is not taxable, but flavored Perrier IS taxable. Ice (frozen water) IS taxable. Taxability is not intuitively logical. It is driven by arcane rules and that is why so many audits are tax due audits.

Purchase taxability errors (Use Tax) also usually occur due to a lack of knowledge of the law. Many people do not understand use tax. A taxable purchase occurs when you buy something you use in your business (for example you buy a computer from out of state). The company mails you the computer but does not charge you tax because they are not required to. (They do not have “nexus” in the state.) You

are required to accrue and remit that tax. If you had bought the computer from Office Depot in Texas, they would have charged you tax. But the fact that the purchase was made out of state does NOT relieve you from owing tax on that purchase. Many audits are submitted on purchases only.

Reporting errors occur when people are less than perfect bookkeepers. Take our convenience store owner again who uses an old manual cash register. In order to report to the state, he has to add his monthly gross, taxable, and sales taxes together and report that to the state. Not being an efficient bookkeeper, he runs this from a calculator and incorrectly keys some figures. Or, he misses a day of sales and therefore under-reports his monthly sales. These are the two areas the state will be checking.

So, when you are audited, your accounting and reporting systems will be of the utmost importance. An audit has nothing to do with what happened. It has everything to do with what you can prove happened.

To summarize, the state is looking for taxability errors on the sales side, untaxed purchases of assets and expense items used in your business, and reporting errors.

The state will ask for as much information in electronic form as possible. They will also want to see purchase invoices to see if tax was paid. The most universal records required by the state for any sales tax audit are:

Bank Statements

Federal Income Tax Returns

Sales Invoices

Purchase Invoices

Reports used to create sales and use tax reports.

If you have these records and they are complete, the sales tax process should be relatively smooth.

What if you do not have these records? Without records, the state is allowed to estimate the audit. The last thing one wants is an estimated audit. The state ALWAYS estimates higher than the actual liability would have been if you had complete records. The justification is they are protecting the state's interests.

Mixed Beverage Tax Update and How to Handle a Comptroller Audit

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House Bill 3572 Highlights of Changes

- Passed 83rd Reg. Session of Legislature (2013)
- Effective January 1, 2014
- TRA goal was to have tax burden shared by business owners and end users (customers)
- Act does lower Mixed Beverage Gross Receipts Tax Rate from 14% to 6.7% (less tax theoretically borne by business owners)
- Imposes new 8.25% Mixed Beverage Sales Tax (more tax theoretically borne by customers)

3

HB 3572 Update (cont'd)

- Total Tax Burden is now 14.95% (8.25% + 6.7%)
- Overall result is 0.95% tax increase from the former 14% gross receipts tax. State gets lots more new tax revenue.
- The two MB taxes are treated as two **separate** taxes
 - Tax Type 73 for MB Gross Receipts Tax
 - Tax Type 63 for MB Sales Tax
 - Separate bond requirements

Separate reports must be made for each tax

Reports must be mailed/filed separately

Different time periods for reporting (discussed below)

Questions on Revenue Accounting or account setups to:
miscellaneous.taxes@cpa.state.tx.us

4

HB 3572 Update (cont'd)

Applicability

- The MB Gross Receipts Tax and MB Sales Tax apply only to taxpayers that hold a TABC Mixed Beverage Permit
- These include:
 - MB - Mixed Beverage
 - RM - Restaurant Mixed Beverage
 - N - Private Club
 - NB - Private Club Beer and Wine Only
 - D - Distillers and Rectifiers
 - TB - Daily Temporary Mixed Beverage
 - TN - Daily Temporary Private Club

No permit will be issued by TABC or Comptroller for the MB Sales Tax

5

The New MB Gross Receipts Tax

- 6.7% Tax Rate rather than old 14% rate.
- Administered same as before just at lower rate
 - See Comptroller Rule 3.1001
- Imposed on Gross Receipts from **sale, service or preparation** of alcoholic beverages and **ice and non-alcoholic beverages** mixed w/alcohol and **consumed on the premises of the permittee.**
- Filed monthly only
- NO EXCEPTIONS to the requirement for monthly filing for MB Gross Receipts Tax

6

New 8.25% MB Sales Tax

- A sales tax is a transaction tax
- It is also considered a “trust fund tax” that is collected by the business for the State
- Customer is primarily obligated for pmt of the tax
- MB Sales Tax is due on each mixed beverage sold, prepared, or served and on ice and non-alcoholic beverages mixed with an alcoholic beverage and sold, prepared or served for consumption on premises.
- Includes bartender fees and setup fees.

7

New 8.25% MB Sales Tax (cont'd)

- MB Sales Tax administered and collected same as regular Chapter 151 Sales Tax EXCEPT:
- No prepayments permitted
- No timely filing discounts given
- Are no local MB Sales Taxes
 - business owner does not need to be concerned with local option tax rates for city, county, metro, special districts; collect 8.25%
- State handles local allocation of the MB Sales Taxes same as before but the two taxes are added together before being allocated at 10.7143%.

8

MB Sales Tax (cont'd)

- Like regular sales tax, the new MB Sales Tax:
- Can be filed monthly or quarterly
- Since MB gross receipts tax is filed monthly, you should consider coordinating your bookkeeping and reports to the same monthly reporting period, i.e. why do one monthly, other quarterly
- Seller can have “tax-included” sales
 - MB Gross Receipts Tax - cannot have “tax included” sales or add gross receipts tax to sales price)
- Seller can elect not to include tax in the sales price (i.e. not to do “tax included” sales).

9

MB Sales Tax (cont'd)

- Whether to do “tax included” sales or not is an important decision
- Seller may elect NOT to do “tax included” sales.
- For sales that are NOT “tax included,” the MB Sales Tax must be added to the sales price
- For “tax included” sales, must provide written notice on customer invoice that tax is included in sales price
- Where tax NOT included: tax added to sales price on customer invoice), eg:
 - For \$1000 sales, \$82.50 in tax added to sales price and remitted to Comptroller

10

House Bill 3572 Update (cont'd)

- Factors driving decision on whether to do “Tax Included” sales”?
 - May depend on whether your POS system can handle itemizing the various taxes.
 - Some small operators may not have a POS system
 - Will affect how the POS system is set up
 - If no POS system, invoice must still state that the tax is included in final sales price
- If not done correctly, you’ll likely suffer at audit time
- Be careful to show that MB Sales Tax is included on service checks. If not documented that tax is included, you will effectively end up paying tax on tax b/c Comptroller will presume **entire sales price is taxable** when you are audited.
- Can’t do “tax included” for the MB Gross Receipts Tax or add the tax to your customer invoice

11

MB Sales Tax (cont'd)

REPORTING “TAX INCLUDED” SALES - EXAMPLES

For \$1000 in “tax included” sales, first back out the tax, eg.

- $\$1000 \div 1.0825 = \924 in taxable sales (rounded up)
- \$76.23 ($\$924 \times 8.25\%$) in MB Sales Tax is reported since that is amount of tax included in sales price
- A lot of bars/clubs will do “tax included” b/c:
 - It’s simple to figure.
 - Owners/Customers like simple round numbers for menu items.
 - Easy to make change
 - \$5.00 (tax included) versus \$5.42 (tax added to sales price)

12

HB 3572 Update (cont'd)

Reporting

- REPORTING MB GROSS RECEIPTS TAX
- Amount subject to tax is same amount as the amount of taxable sales with MB Sales Tax backed out), eg:
 - If taxable sales are \$1000 with tax included, $\$1000/1.0825 = \924 (backing out \$76.23 from \$1000 = \$924 in taxable gross receipts (rounded up))
 - Ergo, the MB Gross Receipts Tax remitted is \$61.91 ($\$924 \times 6.7\% = \61.908 (round up to \$61.91))
 - If MB Sales Tax NOT included, then entire \$1000 is subject to MB Gross Receipts Tax of 6.7% so \$67 in MB Gross Receipts Tax is due

13

HB 3572 Update

Report Forms

- Comptroller indicates that the following tax return forms are to be used (available online):
- MB Sales Tax:
 - Form 63-100
 - Form 63-101 (Outlet Supplement)
 - Taxpayer will report:
 - Total Mixed Beverage Sales (line 4)
 - Total Mixed Beverage Taxable Sales (line 5)
- MB Gross Receipts Tax:
 - Form 67-100
 - Form 67-101 (outlet supplement)

14

HB 3572 Update (cont'd)

Reporting

- Comptroller indicates tax forms will be mailed separately to taxpayers
- Taxpayers will receive three separate returns:
 - Sales & Use Tax (same as before)
 - MB Gross Receipts Tax (no change/filed monthly)
 - MB Sales Tax:
 - Due Date will be 20th of the month following the reporting period like the regular sales tax and MB Gross Receipts Tax
 - First monthly report will be due February 20, 2014

15

HB 3572 (cont'd)

Reporting MB Sales Tax

- Taxpayers will be able to file and pay the MB Sales Tax electronically
- TPs can file the MB Sales Tax either quarterly or monthly but:
 - TPs receiving their MB permit after January 1, 2014 will be set up as monthly filers.
 - Existing TPs filing status (for MB Sales Tax) will be determined based on historical MB Gross Receipts data
 - If determined that the TP will be a monthly filer, they cannot change to quarterly reporting

16

HB 3572 Update (cont'd)

MB Sales Tax Reporting

- Quarterly Filers:
- Comptroller indicates there are about 3100 MB permit holders who qualify for quarterly filing
- A letter to those TPs was to be sent January 3 to give them the option to request monthly status (recommended for bookkeeping consistency between the two types of taxes)
- They can submit the coupon sent with the letter that requests the change
- The request must be mailed back by January 17 to ensure the system will automatically generate the January MB Sales Tax return. The system will mail returns on January 27.
- Requests to change to monthly received after January 27 and before February 20 will have to be manually generated or TP can download form OR to WebFile
- They can also request the change with a p/c or office visit

17

MB Sales Tax (cont'd)

Rule 3.289

- Unlike the MB Gross Receipts Tax, the MB Sales Tax is a debt of the purchaser.
- Must be separately stated on the receipt OR
- Must be a written statement that the sales price includes sales taxes.
- Total amount shown on receipt is ***presumed*** to be taxable
- Records may overcome this presumption
- Out of State sellers must identify the tax as Texas Tax

18

House Bill 3572 Update (cont'd)

Exemptions

- Exemptions: Like the regular sales tax, the MB Sales Tax:
 - May have exemptions to the extent allowed for sales tax (remember that the MB Sales Tax is administered same as regular sales tax)
- To claim an exemption, a Texas MB Sales Tax Exemption Certificate is typically necessary
- NO EXEMPTIONS for the MB Gross Receipts Tax

19

HB 3572 Update (cont'd)

Exemptions

- Religious, Educational & Public Service Organizations (Section 151.310):
- Purchases must relate to the purposes of the organization. Generally Comptroller position is that buying alcohol is not within those purposes (religious, educational or public service).
 - Not fully exempt from paying the MB Sales Tax
 - These Orgs are exempt from charging the MB Sales Tax for sales of alcohol at a **qualifying fundraiser**.
 - Tickets Sold - MB Gross Receipts Tax due on **cost of the alcoholic beverages** served at the event
 - Cash Bar – MB Gross Receipts Tax due on **total receipts from sale and service** of alcohol
 - Appreciation Event – Open Bar with no money exchanged or tickets sold. MB Gross Receipts Tax NOT due but Use Tax is due on purchase of the alcoholic beverages

20

HB 3572 Update (cont'd)

Exemptions

- Tax Code Sec. 151.309 Governmental Entities
- Statutory Exemption for Federal, State, Municipal, County, Special District, other Political Subdivisions
- Like sales tax, these organizations are exempt from the MB Sales Tax.
- 151.309 even includes States and units of governments that border Texas so long as that state or unit of gov't does not impose a similar tax.

21

House Bill 3572 Update (cont'd)

Reporting

- As noted, Mixed Beverage taxes will be treated and reported as two separate taxes
- B/c they are computed differently, different tax figures can be reported for MB Gross Receipts Tax and MB Sales Tax
- Separate reports are to be mailed or filed separately for each tax
- Different Filing Periods
- MB Sales Tax – monthly or quarterly
- MB Gross Receipts Tax – monthly only

22

House Bill 3572 (cont'd)

Bond Requirements

- Three bonds now required - for Sales Tax, MB Sales Tax and MB Gross Receipts Tax.
- Separate bond notices to be mailed by the Comptroller
- Forfeiture and Release Process will not change
- Waiver process will not change
- There are Separate Bond Requirements for each tax type

23

HB 3572 Update (cont'd)

MBGR Bond Requirements

- Taxpayers receiving a MB Permit **prior to January 1, 2014** will post existing minimum MB Gross Receipts bond as follows:
 - MB, RM, D type permits - \$7500
 - N, NB type permits - \$4500
 - NE type permit - \$3000

24

HB 3572 Update (cont'd)

MBGR Bond Requirements

- A taxpayer that receives a MB Permit **on or after January 1, 2014** will post the new minimum MB Gross Receipts Bond as follows:
 - MB, RM, D - \$7500
 - N, NB - \$2250
 - NE - \$1500

Note: HB 3572 does not actually specify these bond amounts. Comptroller frequently sets requirements that are beyond the statutory authorization. In a number of contexts, this is a real legal concern.

25

HB 3572 Update (cont'd)

MB Sales Tax Bond Requirements

- Taxpayers receiving a Mixed Beverage Permit **on or after January 1, 2014** will post the minimum MB Sales Tax bond as follows:
 - MB, RM, D - \$3750
 - N, NB - \$2250
 - NE - \$1500

26

House Bill 3572 Update (cont'd)

- Customer invoices may show the following:
- For MB Gross Receipts Tax
 - A separate statement of the amount of MB Gross Receipts Tax paid; OR
 - A separate statement of combined MB Gross Receipts Tax and MB Sales Tax paid on that sale (don't do this)
 - By law (Tax Code Sec. 183.0212) MB Gross Receipts Tax cannot be separately charged to or paid by the customer and may not be shown as part of the calculation of invoice charges (i.e. no "tax reimbursement charges" for MB Gross Receipts Tax

27

House Bill 3572 Update (cont'd)

- For MB Sales Tax, customer invoices may show the following:
 - Statement that MB Sales Tax is included in sales price
 - Statement of the amount of MB Sales Tax imposed
 - Statement of the combined amount of MB taxes; OR
 - Statement of the combined amount of sales tax and MB Sales Taxes imposed on all items on the invoice.

28

House Bill 3572 Update (cont'd)

Complimentary Drinks

- Resale Exemption for Purchases of Items used in comp drinks
- Sec. 183.043(c) says the sale of an item that will be part of a comp drink is not a sale for resale (how can you know at time of purchase?)
 - Currently, b/c resale exemption does not apply where there is no resale, use tax is to be paid on the cost of taxable ingredients of comp drinks
 - So, in purchasing liquor stock, Permittee theoretically must predict what items will be given away at the time of purchase and pay the use tax at that time (not realistic)
 - **Better solution:** give vendor resale certificate for entire purchase and ACCRUE USE TAX on portions used in comp drinks

29

HB 3572 Update Summary

- HB 3572 makes important changes to tax rates, reporting and tax administration
- Taxpayers will have important decisions to make concerning whether to include the MB sales tax in sales price or not
- Taxpayers bond requirements will be affected
- Reporting for MB Gross Receipts unchanged (monthly)
- Customers will be responsible for the MB Sales Tax BUT if not collected and remitted correctly the business owner may be assessed additional tax in an audit (This is where TRA strategy may break down)

30

HB 3572 Update (cont'd)

Possible Unintended Consequences

- TRA's goal was to take more burden off businesses and place it on customers
- Theoretically the new law does that BUT if the business does not document/report/remit correctly, the MB permittee will be assessed the amount of the tax deficiency at audit time not the individual customers
- There is little recourse for this since permittees will not go back and try to collect from individual customers

31

HB 3572 Update (cont'd)

Possible Unintended Consequences

- May be additional expense to business owners in replacing POS systems or software to handle the multiple tax reporting
- Some small operators may elect to eliminate MB permit and obtain beer & wine permit to avoid more complex reporting
- It is theoretically possible that increased cost of drinks could lead to lower sales (effect of cost on demand)
- Anytime things are made more complex, there may be more attempts to avoid compliance (more likely for small operators)
- Comptroller tax assessments from audits may increase rather than decrease (also b/c of abandonment of error variance policy)(see below)

32

How To Handle a Comptroller Audit

- When you receive a Notice of Audit, what should you do?
 - Don't panic. Approach the audit in a business-like manner
 - Gather the documents requested by Comptroller
 - Organize the documents so that they are understandable
 - Consider hiring a professional that has actual experience as a former Comptroller auditor or hearings attorney
 - Avoid untrained "tax consultants" who can do more harm than good or simply take your money for very little result)

33

How to Handle A Comptroller Audit (cont'd)

- Comptroller uses the "depletion analysis" to perform a MB Gross Receipts audit
 - Depletion analysis is an estimation of your tax liability. Not necessarily representative of actual business operations
 - Auditor estimates additional taxable gross receipts by looking at beginning and ending inventory and using actual/estimated "pour" and average sales price, etc to calculate the theoretical total number of services from your stock (see below)
 - Depletion analysis will cover three categories:
 - Distilled Spirits (mixed beverages)
 - Wine
 - Beer

34

How to Handle a Comptroller Audit (cont'd)

- Depletion Analysis Formula to calculate MB Gross Receipts Tax Base is:
 - **Beginning Inventory** of alcoholic beverages
 - **Plus** purchases of alcoholic beverages
 - **Less** Ending Inventory of alcoholic beverages
 - **Equals** total containers (services) available for sale
 - **Less Exempted Units** for comp drinks, breakage, etc
 - **Equals** Net Units Available for Sale
 - **X** Average retail price per unit
 - **Equals** Audited Gross Receipts
 - **Less** Exempted Units for comp drinks, breakage, etc
 - **Equals** Audited Taxable Receipts
 - **Less** Reported Receipts
 - **Equals** Additional Taxable Receipts (formula NOT in Statute or Rule)
- Problem is this may have nothing to do with the reality of the operation. Depletion Analysis is an “estimation” of Additional Taxable Receipts & Tax

35

How to Handle a Comptroller Audit (cont'd)

- Importance of Inventory Records
- By Rule 3.1001: all alcoholic beverages purchased **are considered sold** unless you have documents showing otherwise
- Keep your Inventory Records so depletion will be performed based on actual sales rather than a false assumption that that more services were sold from inventory than is actually true
- Curiously the Statute and Rule do not require keeping inventory records but the Comptroller holds it against you if you do not

36

How to Handle a Comptroller Audit

The Four P's

- The four P's are central to a Comptroller Mixed Beverage Audit (Price, Pour, Purchases, Proof)
 - Price: Average selling price calculation calculated for each category is critical to a fair audit.
 - This is frequently overstated by auditors
 - Source documents for Price element:
 - POS System
 - z-tapes from cash register
 - Menu prices

37

How to Handle a Comptroller Audit

The Four P's (cont'd)

- Pour: The per drink Pour figure used by the auditor drives auditor calculation of the total number of services available from your inventory; too low a pour can cause large increases in audit liability;
- is derived from:
 - Container sizes used
 - TP information provided on Audit Questionnaire
 - Test Pour (DO NOT pour a smaller than representative pour based on belief auditor will think you are over-serving)
 - By Rule at 1.25 oz used as the Pour if no other reliable evidence

Pour used should be representative of business operation.

Note: Too small a Pour results in auditor calculation of more service units available for sale from Inventory and therefore more additional taxable receipts that are taxed in the audit.

38

How to Handle a Comptroller Audit

The Four P's (cont'd)

- Purchases:
 - Under HB 11 passed several sessions ago, vendors must report your purchases to the Comptroller of distilled spirits, beer, wine and tobacco
 - Sometimes vendor reports are inaccurate; obtaining vendor records to see what was reported should be part of audit defense. Make sure what the State says you bought is actually what you purchased during the relevant audit period
 - State uses purchase information to compare against your reports as an initial determinant of accuracy, fraud (i.e. if you purchases \$1M in distilled spirits and reported \$300K in sales, there is obviously a problem

39

How to Handle a Comptroller Audit

The Four P's (cont'd)

- Proof: Documentation, Documentation, Documentation:
 - An audit has nothing to do with what happened during the audit period
 - It has everything to do with what YOU CAN PROVE happened during the audit period
 - In audit/especially at hearing, adequate source documents are key to obtaining the proper adjustments to the audit result
 - Source documents are original records of your transactions: purchases, sales, comps, wine used in cooking, theft, breakage, spillage, etc, etc After the fact summaries not source records.
 - Not everyone keeps good records and those who don't will suffer the consequences. Remember there are business people and people in business and they are NOT the same
 - Keep adequate source records in the ordinary course of business

40

How to Handle a Comptroller Audit (cont'd)

- Apart from Pour, Price, Purchases, Inventory, other Possible Adjustments to MB Tax Base include:
 - Comp drinks
 - Wine used in cooking
 - Cover charges, door charges, entry fees (sales tax due on these)
 - Theft, Breakage and Spillage (Comptroller will deduct 5% off calculation of liability. If you believe loss is greater than 5%, you must have documentary proof to obtain credit beyond the 5%)
 - Voluntary Gratuities
 - Walked Checks or Tabs
 - Bad Debt charges off on books & deducted for fed tax purposes

See Rule 3.1001 for compliant source documentation needed for these adjustments.

41

How To Handle a Comptroller Audit (cont'd)

- You can hire a professional to assist in audit defense to:
 - Make sure depletion done properly
 - Make sure all appropriate adjustments are obtained based on your source documentation
 - Make sure that depletion represents actual business operations as closely as possible
 - Make proper objections to the audit result as necessary
 - Represent TP in exit conference, possible Independent Audit Review with Audit Manager, and beyond

42

How to Handle a Comptroller Audit (cont'd)

- If I disagree with my audit, what can I do:
 - Itemize your objections at the Exit Conference
 - Ask for an Independent Audit Review (IAR) by an Audit Manager
 - Generally held at local audit office/you may request IAR at your premises
 - Conducted by an audit manager not in chain of supervision
 - Will result in an IAR report indicating what adjustments the IAR officer is recommending if any
 - Upon billing, you can file a Petition for Redetermination of your tax due

43

How to Handle a Comptroller Audit (cont'd)

- On completion of the audit, Comptroller will send a bill called “Texas Notification of Audit Results” detailing the tax, penalty and interest due through the payment date.
- Your deadline for filing for redetermination of the tax is stated in the Notification (typically 20 days)
- You must be timely in filing for redetermination or the audit liability will become final i.e. if you miss the deadline, you will lose your right to a RDT hearing
- Another option: pay the tax and file later for refund

44

How to Handle a Comptroller Audit (cont'd)

- A request for redetermination of taxes may be made by filing a Petition for Redetermination with the Comptroller
- Petition must be in writing and contain a statement of the grounds on which you believe the audit is in error
- Rules require that you itemize each contested item or category of items and provide an explanation of why the audit is incorrect with respect to those contested items or categories

45

How to Handle a Comptroller Audit (cont'd)

- When your request for a redetermination hearing is granted, you will be notified in writing
- The notice will indicate that you have 60 days to provide any exemption or resale certificates that may be pertinent to your case
- After the 60 day period, the case will be assigned to an attorney in the Administrative Hearings Section.
- You will be notified of the name of the attorney to whom it has been assigned by an atty intro letter

46

How to Handle a Comptroller Audit (cont'd)

- If case not settled before then, Hearings Attorney will issue a Position Letter
- Position Letter is an important document in which the Comptroller responds to the specific contentions of your Petition for RDT and will either accept your requested adjustments or reject them
- You MUST respond to the Position Letter or the Hearings Attorney will file a motion to dismiss your petition for failure to respond
- Pleadings may go back and forth
- Each party is entitled to conduct discovery though it is rare

47

How to Handle a Comptroller Audit (cont'd)

- If I can't settle the case with the Hearings Attorney, am I entitled to a hearing in front of a judge on my Request for Redetermination?
- Yes – You have a right to a contested case hearing.
- You may request an Oral Hearing or a Written Submissions hearing.
- Written Submissions hearing is decided by the judge only on pleadings and documentary evidence submitted. (TP almost always loses these).
- Request for oral hearing must be in writing. SOAH requires that the parties provide three suggested dates convenient for the Comptroller and the TP
- Hearings are conducted by the State Office of Administrative Hearings (SOAH) Tax Division
- Judges work for SOAH but, by interagency contract, they are paid by the Comptroller

48

How to Handle a Comptroller Audit (cont'd)

- Oral hearings are held in Austin at SOAH offices, Wm P Clements Bldg, 15th & LaVaca
- Texas Rules of Evidence for bench trials (non-jury trials) apply
- Judges are lenient in allowing evidence into the record (no jury)
- Under the APA, case **MUST** be decided only on evidence of record and not matters outside the record
- Evidence concerning procedures or documentation outside the audit period are not considered relevant
- Decision of the SOAH Judge is memorialized as a “Proposal for Decision” issued w/in 30 days of the hearing (Judge may extend by extending record close date for additional evidence/post-hearing briefs, etc)
- Judges Proposal for Decision is a **recommendation** to the Comptroller
- Comptroller is the final decision maker who will issue the final Comptroller’s Decision

49

How to Handle a Comptroller Audit

- If you are dissatisfied with the Proposal for Decision, you may:
 - File **Exceptions to the Proposal for Decision** providing your points of error indicating why the SOAH judge’s recommendation is in error

If still dissatisfied after final Comptroller’s Decision is issued, you may file a **Motion for Rehearing** presenting reasons why you believe the case was improperly decided

- Upon denial of rehearing, you may file a lawsuit in Travis County District Court
- There are NUMEROUS statutory prerequisites to filing in District Court.
- Get someone that knows what they are doing to handle this b/c some of those prerequisites have been declared unconstitutional.

50

How To Handle a Comptroller Audit

The Error Variance Policy

- Previous to October 2012, Comptroller recognized that the depletion analysis was an “estimation”
- Based on this recognition, Comptroller allowed a certain amount of taxpayer error:
 - Up to 7.5% if you had good records
 - Up to 5% even if you didn’t have good records
 - This meant if your error rate was at or below those thresholds, you were not assessed additional MB Gross Receipts Tax.

With no notice to anyone, Comptroller eliminated this policy.

Net effect of this is “zero tolerance,” meaning even if your error rate based on an estimation is miniscule, you will still be assessed

Comptroller did this by changing provisions in its Mixed Beverage Audit Procedures Manual and TPs would never know. This course of conduct is unfair to TPs and possibly illegal.

51

How to Handle a Comptroller Audit

Fraud Penalty and Personal Liability

- The 50% Fraud Penalty: The law allows Comptroller to add a **50% fraud penalty** where there is “gross error,” i.e. error exceeding 25%
- Unfair b/c even Comptroller admits every depletion analysis is an **estimation**
- Fraud typically involves scienter, legal term for ill intent, in this case, an intent to evade tax
- It is unfair to assume intent to evade tax merely based on an after-the-fact **estimation** of taxes due by an auditor
 - Audit result may be more the result of negligent record keeping than intent to defraud
 - Again, there are business people and people in business and they are NOT the same

52

How to Handle a Comptroller Audit Fraud Penalty and Personal Liability

- Under Tax Code Sec. 111.0611, Comptroller can also assess **personal liability** for taxes owed by the company against an officer, manager or director
- Comptroller has been doing this more and more, using the threat to your personal assets to intimidate TPs into settling
- 111.0611: Comptroller must show personal involvement in some fraudulent activities eg. Signing and filing false tax reports
 - Lot of small operators have only one officer, manager, or director

53

How to Handle Comptroller Audits Sec. 171.255 Personal Liability

- Under Sec. 171.255, Comptroller can also assess officer, director, manager personally for debts incurred by the company **during any period in which their corporate privileges have been forfeited** due to non-payment of franchise tax
- Statute includes any kind of debt incurred during period of forfeiture but Comptroller uses it for tax enforcement
- Easier for them to prove up than fraud. Sec'y of State documents establish who is officer, director or manager as well as period corporate privileges were forfeited

54

How to Handle a Comptroller Audit (cont'd)

- Heartfelt thanks to San Antonio Tourism Council for arranging this seminar
- If we cannot answer your specific question, please provide us with your name and email and the question and we will get you an answer
- If we can help you, please call.

THE END