Post Polak

Goodsell & Strauchler P.A.

Welcome to Edition 10 of The Newsletter from Scott H. Novak, Attorney at Law. The Newsletter is designed to bring timely and interesting topics to accountants and attorneys. Comments and suggestions are always welcome. Feel free to call or write at any time.

New Jersey Mark-On Audits

Many of you have clients who are responsible for sales tax. When the State of New Jersey comes calling to audit for sales tax and corporate business tax (CBT), things can go downhill very quickly if your client does not have the records that the state asks for. There is a record retention requirement in the law. All records relating to sales tax must be kept for a period of four years (NJSA 54:32B-16). What records must be kept? Everything, right down to individual sales receipts. Why aren't daily records good enough? Because without the individual sales tickets, the state cannot tell whether the point of sale (POS) system was on for the entire time that the business was open on any given day. So the first thing to know is that every client who has a POS system must set the system up in such a way that it can retrieve every record for the past four years.

What happens if a record that the state asks for is unavailable? The State can determine the tax from such information as may be available (NJSA 54:32B-19). This can be done based on external indices, such as stock on hand, purchases, rental paid, location, number of employees, cost of goods sold (COGS) and many more. For example, consider a restaurant that cannot produce individual sales slips from three years ago. The state may look at the amount of each item that was purchased, consider inventory on hand, assign a cost to each item and compare it to menu prices. At the risk of oversimplifying the process, that yields a number called a "mark-on," which is averaged for all food items and then multiplied by the cost of goods sold. Often this will yield a sales figure that is approximately double what was actually sold. Sales tax and CBT is increased to match this amount and the restaurant owner is given an outrageous state tax bill.

Unfair and outlandish though this may seem, the state gets away with this every day. So where can we add value? There are many stops along the way. It starts with the original tax return. Overstating COGS will come back to haunt your client in a mark-on audit because the COGS is multiplied by the mark-on. With a restaurant, only food and alcohol belong in COGS. Make sure your client keeps all records for the required amount of time. In addition to POS system records, keep records of every purchase that the client makes. At the beginning of an audit, the state may fill out a "pre-audit questionnaire." With regard to a restaurant, that document will indicate serving sizes and amounts of ingredients used in dishes that are made. Do not sign it on the client's behalf or allow the client to sign it unless the client has carefully gone over it and agrees with the findings. Once signed, it is hard to make changes. If the state comes up with a mark-on number that seems high (5 for food, for example, when you know it should be 3), sit down with the client and go over all of the portion sizes again to make sure there are not errors. Also make sure that all purchases were counted. Look at COGS to make sure that it contains only the expenses that belong there.

There are many pitfalls with mark-on audits. This method of tax determination can ruin your client's business. If faced with this circumstance, don't wait for the State to come back with numbers before you get into the weeds. Once the mark-on numbers are formulated, it is very difficult to walk them back. Get involved early and if needed, get help as early as possible from someone experienced with mark-on audits.

State and Local Tax Deduction in High-Tax States

The state and local income tax deduction has always been an equalizer. For example, take someone in Texas (no income tax) who earned $80,000 and was taxed at the federal level on that amount and compare that person to someone living in northern New Jersey, who earned $100,000, but paid $20,000 in state and local income tax. Under the old law, these two individuals were put on equal footing and subject to tax on $80,000 (yes, I'm ignoring alternative minimum tax). This allowed for taxation on what was actually "disposable." The new law changes the notion of fairness in that it only allows for up to $10,000 of state and local income tax. Under the new law, the person in Texas remains unchanged, maybe even benefits from the higher standard deduction. The person in New Jersey, however, is likely going to be taxed on $10,000 of the $20,000 paid in state and local taxes.

The change in the law has not gone unnoticed by the states that are impacted the most, such as New York, New Jersey, Connecticut, Illinois and California. There are several avenues being considered to combat the ill effects of the new law felt mostly by blue-state residents. The one heard the most is for states to treat taxes, and particularly property taxes, as a charitable contribution. The state gets the same amount of money that it would have otherwise, but the payor of the taxes can take a charitable contribution on his or her return. This will take some thought, as there are issues that must be resolved, such as the question of quid pro quo and donative intent, but some states allow for contributions currently and this would just extend that concept.

Another tactic being considered, at least for income tax, is for the states to shift from an income tax that employees pay to a payroll tax that employers pay. The net effect is the same, but the employer can deduct payroll taxes. Some have been considering a possible constitutional challenge, such as a violation of the equal protection clause. This is a long shot, but certainly worthy of consideration. Double taxation is another constitutional consideration, but is likely a long shot also. This will be a fascinating area to watch during 2018 and beyond.

Sexual Harassment Settlements

Businesses are generally allowed a tax deduction for ordinary and necessary business expenses. There are exceptions to the general rule - for example, a business cannot deduct illegal bribes, certain lobbying and political expenditures and any fine or kickback paid to a government for the violation of any law. There is a new exception under the new tax law. If a business settles a sexual harassment lawsuit AND the payments are subject to a nondisclosure agreement, the settlement is not deductible to the business.

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