ZAPPERS

AN ISSUE BRIEF FROM LEGISLATIVE BUDGET BOARD STAFF

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OBJECTIVE

Zappers allow businesses to hide sales and illegally divert sales tax receipts. Other states have enacted laws to make these devises illegal.

KEY FACTS

- Zappers and phantomware are used to falsify electronic sales data at the point of sale for the purpose of committing tax fraud.
- Customers of merchants using zappers or phantomware sales suppression devices are paying the full sales tax on their purchases.
- Several states have recently outlawed the sale or possession of sales suppression devises.
- There have been no documented cases of tax suppression using zappers in Texas.

BUDGETARY IMPACT

To the extent that sales suppression devises are being used in Texas, the state and local entities imposing sales taxes are losing revenue. The use of sales suppression devices could also affect mixed drinks tax and franchise tax collections.

TAX FRAUD USING ZAPPERS AND PHANTOMWARE

Zappers and phantomware are devises or software used to commit tax fraud. They falsify sales data on electronic cash registers at the point of sale. Zappers can be on memory sticks, removable compact discs, or accessed through an Internet link. Phantomware is a device or program installed directly into electronic cash registers. Zapping software can suppress cash sales and debit or credit card transactions. Tax fraud using these sales suppression devises is difficult to detect through the normal audit process. Merchants using zappers and phantomware collect the full sales tax from their customers, but remit only a portion of those collections to the state. Texas could be losing sales tax, mixed drinks tax, and franchise tax to sales suppression software and devices.

PERVASIVENESSS

Zappers have been found in Germany, Sweden, Brazil, Australia, the Netherlands, Canada, and the United States. It is difficult to determine how pervasive sales suppression devices and software are in the United States because the issue has not been in the forefront of tax enforcement until recently.

There have been three reported cases in the United States. In Connecticut, a grocery chain owner was convicted of concealing $17 million in receipts over 10 years. In Michigan, an Internal Revenue Service investigation resulted in charges against a restaurant chain. The restaurant owner had used zappers to conceal over $20 million in sales during a four year period. The third case involved a man who installed zappers in Detroit area strip clubs.

Recent stings conducted by State of New York Department of Taxation and Finances (NYDTF) suggest that sales suppression devices may be common. NYDTF took over restaurants that had recently closed and sought to buy new cash registers. Seventeen of 20 cash register sellers offered to sell NYDTF suppression devices.

Further indications of the pervasiveness of zappers come from Canada. The province of Quebec has been actively pursuing zappers. They investigated 230 cases between 1997 and 2008. In 713 searches of merchants, they found 31 zapper programs that worked on 13 cash register systems. Quebec's tax authority estimates that in fiscal year 2008 it lost $417 million in tax revenue from tax fraud in restaurants alone.

A 2011 study by the Canada Revenue Agency reported that the agency audited 424 restaurants over a three-year period. The agency found that one third of the restaurants audited had tried to reduce their tax bills by manipulating electronic cash register data. The restaurants had hidden $141 million in sales.

STATE ACTIONS

In 2011, Georgia became the first state to ban zappers. The Georgia law prohibited the sale, purchase, or possession of sales suppression devices. As of July 2012, nine states had banned sales suppression devices, as shown in Fig.1.

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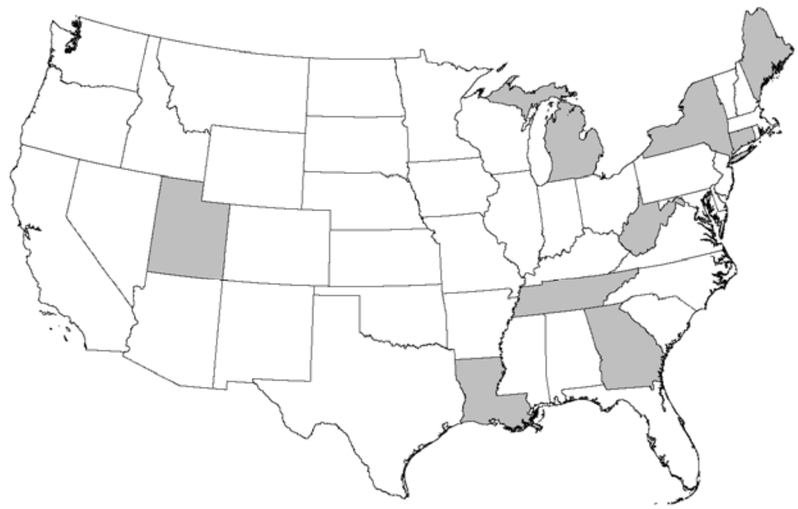
FIG. 1
STATES BANNING ZAPPERS AS OF JULY 2012



SOURCE: CGI Consulting.

Most of the state laws are patterned after the Georgia statute. Before the enactment of these laws, the mere possession of sales suppression devises was not illegal. Before imposing penalties, tax authorities had to document fraudulent transactions.

TECHNOLOGICAL RESPONSE IN QUEBEC

Quebec has taken aggressive action to combat sales suppression. The provincial revenue department requires most restaurants to install tamper-proof devises called a sales recording module or SRMs. The SRMs encrypt and securely store sales data and produce receipts. Restaurants are required to provide receipts to customers. The Quebec revenue agency estimates that enforcement actions will generate $300 million each year. The SRMs devises required by Quebec cost approximately $750 each. The costs to restaurants were offset by an $83 million grant program. Other anti-zapping devises are less expensive than those required in Quebec. Some cost as little as $50, but these devises provide less security and require more audit resources.

TEXAS

There have been no documented cases of zappers in Texas. Texas has not banned sales suppression devices and does not require zapping prevention devises at the point of sale.

ESTIMATE OF LOSSES

A noted authority on zappers from Boston University has made rough estimates of state-by-state revenue losses from sales suppression. He estimates that Texas may be losing $1.6 billion in taxes annually. The estimate is based solely on the level of losses found in Quebec's restaurant and hospitality industry and the relative size of the Texas and Quebec economies. The estimate does not take into account differences in the composition of the two economies. It does not adjust for differences in the Texas and Quebec tax structures. More importantly, there is no direct evidence to suggest that sales suppression in Texas is as prevalent as in Quebec. As such, the estimate is highly speculative.

But even if zappers and phantomware are much less prevalent in Texas, losses could be significant. Texas food services and drinking establishments reported $35.7 billion in receipts subject to the sales tax in 2011. They had another $4.9 billion in mixed drinks sales. If one percent of calendar 2011 restaurant and mixed drinks sales had been lost to sales suppression, state tax losses would have been $29.3 million.

CONTACT

Richard Sorgee Email: Issuebrief@lbb.state.tx.us