STATE OF MICHIGAN
DEPARTMENT OF ENERGY, LABOR & ECONOMIC GROWTH
MICHIGAN TAX TRIBUNAL

BIP, Inc., d/b/a Village Party Store,
Petitioner,

v

MTT Docket No. 322999
Assessment No. N071558

Department of Treasury,
Respondent.

Tribunal Judge Presiding
Cynthia J Knoll

FINAL OPINION AND JUDGMENT

INTRODUCTION

BIP, Inc., d/b/a Village Party Store (Petitioner) appeals an assessment issued by the Michigan Department of Treasury (Respondent), of sales tax, plus interest and penalties, for the tax period beginning November 1, 2000, through June 30, 2004. The assessment is the result of Respondent's audit which found Petitioner's records insufficient to audit sales. Instead, the audit was performed by conducting a sampling of products purchased and Petitioner's retail markups in order to determine the gross sales, both taxable and non-taxable. Petitioner disagrees with Respondent's methodology and calculations, contending that Respondent did not follow proper procedures. The Tribunal disagrees. Because Petitioner failed to maintain adequate records of its business, Respondent was authorized to determine and assess the tax based on the best available information. Despite some legitimate concerns over certain aspects of Respondent's approach to the audit, Petitioner has failed in its burden to prove an amount of tax other than that as assessed, and the assessment is affirmed.

BACKGROUND

Petitioner owns and operates the Village Party Store, located in Lansing, Michigan. Respondent conducted a sales tax audit of the period November 1, 2000, through June 30, 2004. Respondent's auditor determined Petitioner had underpaid sales tax based on its conclusion that Petitioner had overstated the non-taxable food deduction and understated its taxable sales.

Respondent issued an Intent to Assess and imposed a 10% negligence penalty because of Petitioner's failure to properly record purchase and sales figures. Petitioner requested and was granted an informal conference with Respondent's Hearing Division, which was held on February 21, 2006. The Hearing Referee found Respondent's audit determination to be correct and recommended the Intent to Assess be assessed as originally determined. Accepting the Referee's recommendation, Respondent issued its Decision and Order of Determination on April 18, 2006, and Final Bill for Taxes Due (Final Assessment) N071558, for $95,718.00 tax, $9,573.00 penalty, and $20,283.92 interest, as accrued through May 2, 2006.

Petitioner filed a Non-Property Tax Appeal Petition Form with the Michigan Tax Tribunal, Small Claims Division on May 18, 2006, appealing the assessed tax, interest and penalties. Petitioner stated in its Small Claims Petition form that the basis for the appeal was "[t]he State of Michigan Auditors have intentionally made gross errors in auditing the . . . petitioner." The Tribunal ruled that the Small Claims Division did not have jurisdiction in this case, and Petitioner filed a Petition with the Entire Tribunal on September 20, 2006, stating that it "does not admit liability for the taxes, penalty or interest as claimed."

A hearing was held June 3-5, 2008, before Judge Susan Grimes Width, the CPA Member of the Michigan Tax Tribunal. Judge Width's appointed term ended prior to her completing the decision in this case. Pursuant to TTR Rule 140, CPA Member, Judge Cynthia Knoll was assigned to continue the proceedings and decide this matter.

PETITIONER'S CONTENTIONS:

Petitioner appeals the sales tax assessment "due to the inaccuracies of the audit conducted by [Respondent]."[1] Petitioner objects to the methodology used by Respondent in conducting its audit for several reasons. First, Petitioner argues Respondent is required to "pick the statistical sample in a random manner" and that the auditor "failed to sample in a random manner."[2] In its Trial Brief, Petitioner stated, "Respondent determined that Petitioner's records were inadequate, . . . [therefore] it was required to conduct a random sampling as part of its assessment; which is a requirement of the [Audit Sampling M]anual promulgated by Respondent." Pet TB, p. 2 Petitioner stated that its CPA had the records available for every

[1] Petitioner's Trial Brief, p. 1 (hereinafter Pet. TB)
[2] Petitioner's (written) Closing Argument (hereinafter Pet. CA)

month, yet was told to provide purchase records for September and October 2003, only. "The selection of September and October were not random but calculated to use the months with the highest purchase of alcoholic beverages form [sic] its suppliers." Pet TB, p. 4 Petitioner alleges that Respondent "consistently chose the same 2 months in this and several other audits."[3] Petitioner believes that Respondent "chose the highest inventory purchase months that are standard in this industry, which skewed the total purchases throughout the year." Pet TB, p. 2

Petitioner cited page 8 of Respondent's Audit Sampling Manual, which Petitioner claims "directed the auditor to review the taxpayer's general business practices and history, as any change could affect the sample." Pet TB, p. 5 Specifically, Petitioner suggests that "[changes] in locations, seasonal and business cycle changes, and type of products or services, pricing, product lines, etc.," might be pertinent to its case. Pet TB, p. 5 Petitioner alleges that because Respondent's auditor did not follow the manual, and selected September and October, the "results were flawed and statistically improper." Pet TB, p. 5 Petitioner further argues that "the month of September 2003, is an anomaly, and should be discarded from the test period."[4]

Second, Petitioner disagrees with Respondent's claim that it has understated its purchase records. Petitioner believes that it was "Respondent's flawed system of sampling" that resulted in the conclusion that "Petitioner was not reporting all of it's [sic] purchases." Pet CA Petitioner informed its CPA "that the purchases were always paid and reported by it." Pet TB, p. 6 Petitioner's CPA testified that he performed a six-month sample[5] and Petitioner believes that "[if] the tax liability is calculated based upon six consecutive months in 2004, the Petitioner would not owe anything to the State of Michigan." Pet TB, p. 6 Petitioner contends that the auditor ignored purchase records for the sample periods, and ignored the fact that the markup for food is higher than the markup for beer, wine, cigarettes and liquor.

Third, Petitioner challenges Respondent's contention that it did not provide any records for bottle deposits and cigarette rebates. Bottle deposits and returns are not subject to sales tax

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[3] Pet. TB, p. 2; Petitioner argues that Respondent's auditor was inexperienced and did not follow its own procedures in selecting the audit sample. Petitioner attacks the auditor's competency and states that he "changed its position several times before reaching the conclusions that are being reviewed because it was shown time after time that it was consistently wrong." Petitioner alleges that the result was a lack of consistency in audits of different taxpayers netting vastly different results, and a gross overestimation of sales tax in this case.

[4] Pet. TB, p. 6; The store is located near the Michigan State University campus and when the fall semester started in September 2003, the store purchased large volumes of inventory.

[5] Transcript, p. 375 (hereinafter Trans.)

and therefore deposits should be eliminated from purchase records of taxable goods. Petitioner alleges that Respondent's auditor "neglected to record bottle deposits on pop and beer," and that the auditor's supervisor stated that "bottle deposits are always a wash." Pet CA Petitioner's CPA calculated the bottle deposits and returns for the sample period, showing that "they are not a wash because bottle deposits are never equal to bottle returns." Pet. CA Petitioner also stated that its CPA "provided invoice records from beer companies . . . [and t]he auditor completely ignored the bottle deposits."[6] Petitioner contends that, as a result, Respondent "is computing food for human consumption percentages based on the cost of beer including bottle deposits . . . " and therefore Respondent has assessed a tax of 6% on the deposits including a 25% markup. Pet CA

Petitioner cites numerous concerns it has with Respondent's approach to calculating a markup percentage. It believes that the inclusion of bottle deposits "artificially inflates the amount of sales of taxable alcoholic beverages, which in turn reduces the percentage of sales attributed to non-taxable groceries." Pet TB, p. 8 Including bottle deposits in gross sales also increases the perceived profit margin on beverages. Petitioner disagrees with the auditor's comparison of September, 2003, costs to April, 2004, sales prices. Because the cost of goods increases with time, "this [approach] will always result in higher markup percentages."[7]

Petitioner contends that Respondent "completely ignores the volume of an item sold when [it] calculate[s] the markup percentages." Pet TB, p. 9 Petitioner submitted evidence it believes shows that "store owners increase inventory in September and October because the Michigan Liquor Control Commission gives a higher discount in those months for purchases, due to volume increases [for] college football season, NFL football season, and holidays."[8] Petitioner's CPA testified that a weighted volume of purchased goods should be considered in determining a general markup percentage. Trans. pp. 338 and 518-519.

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[6] Pet. TB, pp. 6 – 7; Again, Petitioner attempts to attack Respondent's auditor by noting the "many errors the auditor made in preparing records from purchase invoices" and relying "blindly on invoice records from third parties, regardless of how many errors have been made by those third parties."

[7] Pet. TB, p. 9; Petitioner takes another stab at Respondent's auditor by pointing out that he made numerous errors even in noting down the sales prices in April 2004, and states further that "he may not have known what he was doing."

[8] Pet. TB, p. 8, The Tribunal notes that this fact would indicate a higher markup overall percentage because a greater discount applied to a higher volume of purchases results in a greater weighted markup percentage. Nevertheless, Petitioner's argument regarding volume has validity.

Petitioner also contends that Respondent made two errors with regard to cigarette markups. Respondent did not allow any deductions for cigarette rebates despite Petitioner showing evidence of rebate contracts and checks. Purchase records show that the cigarette companies offered rebates of $6 to $8 per carton (10 packs) of cigarettes off the purchase price of the retailer. Pet. CA Petitioner contends that these rebates should be subtracted from the purchase price before any markup is made to calculate sales. Petitioner also argues that "more than 70% of the cigarettes purchased were Marlboro and Newport, which has [sic] a markup of less than 10%." Pet TB, p. 10 Again, "Respondent has refused to calculate markup percentages based on volume." Pet TB, p. 10 Petitioner believes that a calculation of markup by brand volume would result in "significantly less than the auditor's categorical markup percentages, and the 'industry standard' markup," used by Respondent. Pet CA

Petitioner challenges Respondent's approach to calculating the average markup without considering the change in inventory levels. Petitioner argues that it "should not have to pay tax on inventory it has not sold." Pet TB, p. 11 Petitioner points to the balance sheets included in its Federal Income Tax Returns to show that inventory increased in each of the years at issue.[9] Petitioner acknowledges that it is "required to pay sales tax that is collected on the sales of taxable merchandise . . . [and] not required to pay sales tax on items which have not been sold yet." Pet CA Petitioner alleges that "[t]he result in failure to consider that part of the inventory purchases that increased the overall amount of inventory, results in the assumption that all of the inventory that was purchased was sold, artificially increasing the amount of sales tax calculated by the auditor." Pet CA Petitioner stated that Respondent's auditor did not request inventory records and despite having copies of Federal income tax returns with ending inventory totals, Respondent's auditor "still did not incorporate the increase in inventory in his . . . Audit Determination." Pet CA, Test. p. 658

Petitioner disagrees with Respondent's reliance on records provided by the Michigan Liquor Control Commission because those records could be erroneous, as they do not reflect returns, breakage, or non-delivered items. Pet TB, p. 11 Petitioner brought forth evidence in the form of an invoice with a hand written adjustment that it believes proves that the Liquor Control Commission did not adjust invoices for breakage. There was no calculation for breakage or

[9] Petitioner's 2004 Federal Income Tax Return was not admitted into evidence, and therefore any increase or decrease could not be verified for that year.

spillage or non-delivery of items that appeared on invoices but were removed by the delivery man at the point of sale. Pet CA Petitioner's CPA testified that "they never go back and correct their invoice records on the computer." Trans. p. 383

Petitioner stated that "after making the categorical analysis for markup percentages, [the auditor] used an 'industry standard' markup of 25%." Trans. p. 118 Petitioner believes Respondent "completely disregarded the categorical markup percentages and failed to show why [it] should be allowed to use 'industry standard' average markups." Pet CA Petitioner asserts that the auditor and his supervisor were not knowledgeable about where the information was gathered from to determine the "industry average," nor had they examined industry trends. Pet CA It disagrees with Respondent's approach to using "an average markup of 25% and appl[ying] it across the board to food, cigarettes, beer and everything else, which is clearly a wrong way to estimate sales tax, as the margin of profit on cigarettes and beer is much lower." Pet TB, p. 9

In summary, Petitioner contends that it does not owe any additional taxes and that "Respondent's entire audit is based on phantom industry standards, for which Respondent could find no witness to testify as to the source of the standard, on assumed understated purchases, which lead to assumed understated sales." Pet CA

RESPONDENT'S CONTENTIONS

Respondent contends that Petitioner "failed to maintain adequate records of its business that would allow [Respondent] to determine the correct amount of sales tax for the period."[10] As a result, Respondent was authorized, pursuant to MCL 205.67(1), to determine and assess the tax based on the best available information. Respondent stated that "[a]n assessment based on available information when the records required by MCL 205.67 are not maintained is *prima facie* correct, and the taxpayer has the burden of proof to refute the assessment."[11] Petitioner has the burden to "come forward with positive proof of his income, as distinguished from the negative burden of disproving the department's computation." *Kostyu v Dep't of Treasury,* 170 Mich App 123; 427 NW2d 555 (1998). The burden of proof also requires Petitioner to produce records to support its actual gross proceeds and the actual amounts of it nontaxable exemptions.

[10] Respondent's Trial Brief, p. 7 (hereinafter Resp. TB)
[11] Respondent's Post Trial Brief, p. 2 (hereinafter Resp. PTB)

Vomvolakis v Dep't of Treasury, 145 Mich App 238, 244-245; 377 NW2d 309 (1985).

Respondent argues that Petitioner "did not maintain and preserve records of its purchases and receipts" and "has not provided any additional records of its actual purchases and receipts for the years in issue to refute the assessment." Resp. TB pp. 1-2

Respondent stated in its prehearing statement that Petitioner's "accountant disputed several issues like the net bottle deposits and amounts for cigarette discounts/rebates, but did not provide any records of these amounts that would allow the auditor to make a determination base[d] on actual figures. As such, the auditor used the best information it could obtain."[12] Respondent's auditor testified that he used price information on particular brands of cigarettes because "that was the only information available to me, so by default it was the best available information." Trans. p. 171 Similarly, he testified that he was not provided credit memos issued by the Michigan Liquor Control Commission for breakage or returns, and therefore made the assumption that breakage was factored into the monthly invoices. Trans. p. 163

Respondent discredited Petitioner's specific contentions primarily by pointing to the lack of reliable records. Addressing Petitioner's dispute over retail markup percentages, net bottle deposits, and amounts for cigarette discounts/rebates, Respondent argued that Petitioner "did not provide any records of these amounts that would allow the auditor to make a determination based on actual figures." Resp. TB p. 3 In reaction to Petitioner's concern that "the sales were over stated because [it] had been accumulating inventory and thus all purchases did not translate into sales," Resp. TB p. 3 Respondent stated "[Petitioner] never provided any beginning and ending inventory to substantiate this claim." Resp. TB p. 3

Respondent alleges that "[a]ll financial aspects of [Petitioner] were controlled by the owner with few internal controls. [It] did not maintain adequate records of its purchases, inventory, cigarette rebates/discounts, bottle deposits and returns, or the daily 'Z-ring' register tapes that would show whether a purchase was keyed as taxable or non-taxable." Resp. TB p. 2 Respondent's auditor testified that the daily cash register tapes (or Z-ring tapes) are important because "you can see how much tax is collected on a particular day and if there are problems with categories or if a certain category isn't being treated correctly on the cash register, it can go into non-taxable - a review of the daily tapes…help(s) ascertain what information is actually going into [the tax return reports]." Trans. 533

[12] Respondent's Prehearing Statement (hereinafter Resp. PS

Respondent concluded that records were insufficient and therefore, performed the audit "by conducting a sampling of the products purchased and seller's retail markups in order to determine the gross sales and the percentage of gross sales that were deductible food/grocery." Resp. TB p. 2 Respondent's auditor employed a "block sample"[13] audit methodology by initially examining two months: September and October 2003. The auditor testified that those months were considered generally representative of business activity because they had no major holidays within them, and the months were not in the middle of either winter or summer. Trans. pp. 41-42 Respondent stated that "after Petitioner complained that September was atypical, [Respondent] allowed [Petitioner] to conduct a self audit of February and March [2003], and the auditor isolated September and applied it as one twelfth for each audit year."[14] Petitioner's CPA performed the examination of the additional two months. The results of the four-month sample period were then applied to the entire audit period. Resp. TB

Respondent's auditor examined purchase invoices for the sample months and categorized purchases as *liquor, beer and wine, cigarettes, other taxable,* and *food* (nontaxable). [Emphasis added.] Resp. TB p. 2 He also compared the purchase invoices with check stubs and any check stub without a corresponding invoice was entered as *other taxable*. Resp. TB p. 2 For example, Respondent's auditor testified that there were no purchase invoices for Sam's Club yet there were check stubs; therefore, those amounts were recorded as "other taxable." Trans. p. 541 Respondent also claims that its auditor "checked with vendors to try and verify purchases where there were no invoices." Resp. TB p. 2

Respondent's auditor testified that the amount of purchases in the four-month sample were greater than the amount recorded in the general ledger. He therefore concluded that purchases were understated. Trans. p. 553 He further testified that "[t]he auditing methodology is [such] that if understated purchases are uncovered, . . . the assumption is that sales are correspondingly being understated." Trans. p. 533 He went on to say that he determined the food deduction was overstated by looking at the amount of gross receipts reported on the original

[13] Respondent's auditor testified that a "block sample is a set time period that you sample an employer sample from. So September and October was the block that the purchase invoices were sampled from." Trans. p.71

[14] Resp. PTB, p. 1, Respondent's auditor testified that at the time of this audit, it was the Department's position that September and October be used for the sample, "unless it was objected to by the taxpayer, then we would consider other months." Trans. p. 42

sales tax return.[15] From that, he deducted liquor sales as reported by the Michigan Liquor Control Commission, lottery commissions, and sales tax to find total non-liquor sales. The auditor then deducted the amount reported by Petitioner as non-taxable sales. Based on this analysis, Respondent's auditor testified that Petitioner "is paying enough sales tax roughly to cover his liquor sales and nothing else." Trans. p 565

Respondent contends that Petitioner underreported its purchases and therefore "the assumption is that the sales are being underreported." Trans. p. 82 Respondent stated that "we believe based on the trends in 2003, that cigarette purchases from Sam's have not been taken into account, that skews [the amount of purchases] quite a bit." Trans. p. 13 In response to Petitioner's criticism that he did not consider inventory increases when evaluating the amount of purchases, Respondent's auditor testified that he did not have the specific documentation required to make the adjustment. He explained that "you would have to know how to distribute the . . . increase over the [audit period] and specifically what merchandise the inventory was going into, whether it was beer and wine, food, potato chips, pop." Trans. p. 80 Regarding the use of markups based on weighted sales volume[16], the auditor testified that he would have used them "[i]f they were suggested and documentation was provided that was adequate to allow me to use them" Trans. p. 578 Notwithstanding individual product markups, Respondent assumed that everything except liquor is marked up by 25 percent, which included the 6 percent sales tax. Trans p. 125

Respondent disagrees with Petitioner's allegation that it has improperly taxed beverage container deposits in the audit. Respondent's auditor testified that "after the issue was raised [he] contacted beverage distributors and got annual reports for as many as [could] provide them and made a bottle deposit estimate based on that information [for] . . . the four [sample] months . . . . Resp. PTB p. 8 He then made an estimate, which he applied to the purchase sample. Respondent contends that evidence "shows that the bottle amount was removed from the audit

[15] As noted by Respondent in its Post Trial Brief, p. 13, Petitioner argues that it did not overstate the non-taxable food deduction, yet it "offered no evidence or calculations regarding the actual nontaxable food deduction". Further, Petitioner's CPA "admitted that none of the trial exhibits would refute the non-taxable food deduction and when asked if he prepared any spreadsheets to dispute the deduction, he replied, 'No dispute' (Trans. p. 496)."

[16] Petitioner argued at hearing "…if you are going to … randomly pick[] four brands of cigarettes, one of which is a big seller and the other three don't sell at all, that is not an accurate representation of a proper markup of cigarettes….", Trans. p. 138

merchandise purchases to arrive at the audit cost of goods before applying the markup . . . [so] there are no bottle amounts in the audit sales amounts." Resp. PTB, citing Trans. p. 576

Respondent contends that Petitioner has not established that it was entitled to any deduction for cigarette rebates. Respondent believes it never taxed any cigarette rebates during the audit period nor as a result of the audit. "Rebate checks were not included in gross sales, nor were they one of the six categories that made up the audit cost of goods, which were determined based on purchases." Resp. PTB p. 6 Further, Petitioner "argued that the rebates were somehow taxed because the rebates reduced Petitioner's selling price for certain brands, and the markups did not account for this reduction in sales price." Resp. PTB p. 6 Respondent replied by stating "Petitioner has not provided adequate records to verify the purchase and sales price of these cigarettes, and the rebate check stubs and sample contracts, most of which were outside the audit and sampling periods, do not account for the amount claimed by Petitioner." Resp. PTB p. 6 Respondent argues that "…the limited evidence simply does not add up to … the amount of rebates claimed by Petitioner…, and Petitioner bears the burden of producing records to support the actual amount of its exemptions."[17]

Respondent asserts that liquor sales were calculated based on the best available information. Petitioner argues that Respondent improperly relied on records from the Michigan Liquor Control Commission (MLCC), which allegedly contained errors. The purported errors relate to credits for broken bottles that the MLCC records did not account for. However, Respondent's auditor testified that, in his experience, the MLCC provides credit memos to account for breakage and that he did not see any credit memos in this case. Petitioner's CPA testified that he asked the auditor to ask the MLCC how they account for breakage. Trans. p. 18 Respondent again noted the "inadequate records in this case" and reiterated that "Petitioner . . . bears the burden of proof." Resp. PTB p. 10

Respondent contends that Petitioner has not shown that the markups used by Respondent were improper. Although Petitioner complains that the sales prices were recorded in 2004 and the periods in 2003 were sampled for cost[18], Treasury defends its reliance on the best available information. Resp. PTB p. 11 Given the lack of invoices and daily sales records to document purchase and sales costs during the sample period, and the fact that Petitioner's allegations of

[17] Resp. PTB p. 7, citing *Vomvolakis v Dep't of Treasury, supra*
[18] In other words, without considering price fluctuations or increasing prices of both purchases and sales.

cigarette markups cannot be verified, Respondent believes Petitioner has failed to meet its burden of providing proof of income, sales or gross proceeds. Resp. PTB p. 12 Respondent further alleges that "the mark-ups determined by the auditor were consistent with the mark-ups supplied by [Petitioner] at the initial [audit] interview." Resp. PS

Respondent denies that it taxed lottery sales[19] "because they were not included in gross sales and did not [sic] one of the six categories that made up the purchase spread to determine the gross adjustment"; (i.e., *liquor, beer and wine, cigarette, other taxable, nontaxable food,* and *taxable prepared food.)* [Emphasis added.] Resp. PTB p. 5 Respondent disagrees with Petitioner's speculation that lottery sales may have been taxed because they might have been deposited under the general sales account. Respondent contends that "the audit determined the tax due by determining a gross sales adjustment based on the categories listed above based on purchases." [Emphasis added.] Resp. PTB p. 5

In its Post Trial Brief, Respondent asks the Tribunal to find that Petitioner's evidence was not credible. Citing several examples, Respondent stated that Petitioner's CPA "repeatedly changed his testimony on the witness stand." Resp. PTB p. 3 "Assuming that [Petitioner's CPA's] testimony was truthful, his testimony indicates, at the very least, that he no longer had sufficient knowledge of the records and record keeping to provide accurate testimony." Resp. TB p. 4

In summary, Respondent contends that Petitioner "failed to maintain adequate records at its business.,,.[and a]s a result, the tax [was] correctly determined from available information and is *prima facie* correct." Resp. TB p. 5 Respondent states that "it is not enough for [Petitioner] to simply criticize [Respondent's] determination of tax." Resp. TB p. 5 Petitioner has the burden of proof "to come forward with positive proof of [its] income, as distinguished from the negative burden of disproving the department's computation."[20] Respondent looked to *Vomvolakis v Dep't of Treasury, supra,* when it stated that "[t]he burden of proof also requires Petitioner to produce records to support it[s] actual gross proceeds and the actual amounts of its nontaxable exemptions." Resp. PTB p. 2 "Petitioner has failed in its burden of proof to rebut the presumption of liability because it has not provided proof of income or deductions that would rebut the audit." Resp. PTB p. 3

[19] Petitioner alleges in its original Petition that Lottery gross receipts were included as taxable items. Resp. PTB p. 2, citing *Kostyu v Dep't of Treasury, supra.*

FINDINGS OF FACT

Petitioner is engaged in a retail business and is generally required to collect and remit sales tax. Petitioner's sales consist of liquor, beer, wine, soda pop, cigarettes, lottery tickets, food and other miscellaneous goods. Certain sales or receipts are specifically exempt from tax, including sales of food, bottle deposits, and lottery sales. Respondent conducted an audit of Petitioner's business and determined that Petitioner's records were inadequate to effectively audit sales. Respondent therefore employed an understated purchase audit method. Respondent also used a block sampling method, choosing to review the months of September and October, 2003. Petitioner objected to the audit of these two months and performed a self-audit of February and March, 2003. Respondent accepted Petitioner's audit results, adding them to the sample for extrapolation, and isolating the results of September to one-twelfth of each year in the audit period.

Petitioner's internal controls at the store were weak. The same individuals had control of all financial aspects of the business including sales, purchases, payments, and the recording of these transactions. This created an inherent vulnerability and resulted in little reliability of the records. Daily cash register tapes (Z-ring tapes), which show the amount of sales tax collected, were discarded and not available for the audit. Invoices or other source documentation was not available to support purchases of cigarettes from Sam's Club. Credit memos were not made available to support Petitioner's contention that purchases from the Michigan Liquor Control Commission were overstated. Full and complete documentation was not made available to accurately determine the total cash rebates from cigarette manufacturers/distributors. Cigarette markups were also difficult to accurately determine because purchase price information was from the sample months during 2003 whereas the sales prices were determined during the actual audit site-visit made in 2004. Beginning and ending inventory levels, by merchandise or product category, were not made available to Respondent in order to reflect an inventory increase in the gross sales calculation. Information regarding bottle deposits was difficult to obtain, although Respondent was ultimately able to estimate a reasonable net bottle deposit and ensure it was not included in the gross sales determination.

Despite the poor condition of Petitioner's record keeping, the Tribunal finds that Respondent's audit was not without its own inherent weaknesses. The statistical method

employed, based on a block sample method, is acceptable and not considered biased. However, determining a sales tax which is statutorily based on gross sales price, by looking to the retailer's purchase price and applying a markup, seems to be an "upside-down" or inverted approach to an audit. The tax is imposed on sales price, not cost plus some arbitrary amount. Nevertheless, the courts have blessed the methodology because "a fair reading of the relevant statutes indicates that the Legislature intended to give the Department of Treasury power to base assessments on the best information that it could obtain."[21]

Respondent acknowledged and agreed with Petitioner that an increase in inventory over time would artificially overstate the gross sales under this audit methodology. But except for pointing to the lack of documentary support, Respondent did not consider the inventory issue in its calculations. Trans. p. 79 After making an attempt to determine an average markup on cigarettes, food, beer and soda pop, Respondent seemed to abandon the categorical findings in favor of an "industry standard" of 25%. A flat markup rate for all products is arbitrary and likely has no direct correlation to the products sold, particularly in light of Petitioner's argument that a weighted markup is warranted to account for various product sales volumes. Respondent's auditors did not even know from where or how that percentage was determined, yet they believed it was a reasonable approach to determine Petitioner's gross sales.

Petitioner made valid arguments regarding bottle deposits, cigarette rebates, and credits for breakage, spoilage, theft, customer returns and vendor returns. Failure to consider these issues in a "cost plus markup" based audit methodology could certainly result in errors. However, it is Petitioner's burden to prove such errors exist and the proper amounts to be included in the calculations.

The Tribunal finds that Petitioner failed in its burden of proof. Respondent appropriately determined that the records maintained and returns filed were inaccurate or incomplete. Respondent's determination of the amount of tax due was based on the best information that was available. Gross sales were understated by $346,910 and the food/grocery deduction (i.e., exemption) was overstated by $1,303,019 for the audit period. The audit resulted in a sales tax liability of $95,718.

CONCLUSIONS OF LAW

[21] *Vomvolakis v Dep't of Treasury, supra.*

The assessment at issue in this matter is for unpaid sales tax. The Sales Tax Act, 1933 PA 167, provides for the levy and collection of a sales tax on the transfer of ownership of tangible personal property. Section 2 of the Act, MCL 205.52, provides,

> (1) Except as provided in section 2a, there is levied upon and there shall be collected from all persons engaged in the business of making sales at retail, by which ownership of tangible personal property is transferred for consideration, an annual tax for the privilege of engaging in that business equal to 6% of the **gross proceeds** of the business, plus the penalty and interest if applicable as provided by law, less deductions allowed by this act. [emphasis added]

"Gross proceeds" means sales price. MCL 205.51(1)(b) "Sales price" is defined (in relevant part) as:

> [T]he total amount of consideration, including cash, credit, property, and services, for which tangible personal property or services are sold, leased, or rented, valued in money, whether received in money or otherwise, and applies to the measure subject to sales tax. Sales price includes the following…:
>
> (i) Seller's cost of the property sold. MCL 205.51(1)(d)

Certain items sold by Petitioner are not subject to tax. Pursuant to MCL 205.54g, the following are exempt from the sales tax:

> (a) Sales of drugs for human use that can only be legally dispensed by prescription or food or food ingredients, except prepared food intended for immediate human consumption.
>
> (b) The deposit on a returnable container for a beverage or the deposit on a carton or case that is used for returnable containers.

The statute requires that taxpayers maintain adequate records to ensure the appropriate taxes are paid. MCL 205.67, (repealed by P.A. 2008, No. 438, § 1, Imd. Eff. Jan. 9, 2009), states in pertinent part:

> (1) A person liable for any tax imposed under this act shall keep accurate and complete beginning and annual inventory and purchase records of additions to inventory, complete daily sales records, receipts, invoices, bills of lading, and all pertinent documents in a form the department requires…. If the taxpayer fails to file a return or to maintain or preserve proper records as prescribed in this section, or the department has reason to believe that any records maintained or returns filed are inaccurate or incomplete and that additional taxes are due, the department may assess the amount of the tax due from the

> taxpayer based on information that is available or that may become available to the department. That assessment is considered prima facie correct for the purpose of this act and the burden of proof of refuting the assessment is upon the taxpayer.

In addition, the Michigan Administrative Code provides:[22]

> R 205.23 Records.
>
> Rule 23. (1) The department, through its field auditors and other employees, may examine the books, records and papers of any person liable for payment of the sales and use taxes. It may issue a subpoena requiring any person to appear for examination and produce any books, records or papers within the scope of the inquiry.
>
> (2) It is the duty of every person engaging in any business subject to the tax to keep and preserve suitable and adequate records of his business to enable such person, as well as the state, to determine the correct amount of tax for which he is liable.
> (3) Failure to produce and keep records for the purpose of examination by the department will be considered willful noncompliance with the sales tax law and subject to its penalties. In the absence of sufficient records the department may determine the amount of tax due the state by using any information available whether obtained at the taxpayer's place of business or from any other sources, and assess the taxpayer for any deficiencies, plus penalties.

Respondent is granted authority to examine and audit Petitioner's records if it believes all taxes have not been paid. MCL 205.21 states:

> (1) If a taxpayer fails or refuses to make a return or payment as required, in whole or in part, or if the department has reason to believe that a return made or payment does not supply sufficient information for an accurate determination of the amount of tax due, the department may obtain information on which to base an assessment of the tax. By its duly authorized agents, the department may examine the books, records, and papers and audit the accounts of a person or any other records pertaining to the tax.

Respondent determined that the books and records provided to its auditor by Petitioner were inadequate and failed to meet the statutory requirements. Respondent therefore based its audit conclusions on the best information available, as is consistent with MCL 205.67 and *Vomvolakis, supra*. The last sentence of MCL 205.67 established the burden of proof as being

[22] 1999 AC, R 205.23

upon the taxpayer. The taxpayer must show that the assessments are improper, unlawful or inappropriate and what, if any, is the correct and proper tax liability.

This Tribunal, upon due, careful and deliberate consideration of the entire record in this matter, concludes that Petitioner did not maintain complete and accurate records as required and that Respondent acted reasonably in its audit methodology basing its assessment upon the information that was available and obtainable. Although the Tribunal agrees with Petitioner that certain of Respondent's calculations and methodologies likely result in imperfect estimates and not exact tax determinations, Petitioner has failed in its burden to prove what the tax should be.

The Tribunal finds that the audit performed by Respondent's auditor was comprehensive, as was Respondent's audit report. Respondent's auditor used the information, materials, and documents provided by Petitioner's CPA. The audit report included Petitioner's purchases and a determination of understated purchases, a calculation of markup for certain products and categories, a schedule showing the non-taxable food determination, and bottle deposit calculations. Respondent made appropriate changes to the assessment when presented with adequate and reliable information; for example, the inclusion of two additional months in the block sample and adjustments for bottle deposits. In contrast, Petitioner did not offer any alternative tax amount due. Petitioner did not present any evidence to counter Respondent's audit report findings or to support the amounts Petitioner originally asserted in its annual Sales, Use and Withholding returns. Petitioner simply pointed to Respondent's flaws and errors. Petitioner has the burden of proof to come forward with positive proof of tax, as distinguished from the negative burden of disproving Respondent's computation. Therefore, the Tribunal finds that Petitioner did not provide sufficient, credible and reliable evidence to support an amount of sales tax due for the periods at issue other than the amount as assessed in Respondent's Final Bill for Taxes Due.

Regarding the imposition of the negligence penalty imposed by Respondent, MCL 205.23(3) provides:

> (3)…if any part of the deficiency or an excessive claim for credit is due to negligence, but without intent to defraud, a penalty of $10.00 or 10% of the total amount of the deficiency in the tax, whichever is greater, plus interest as provided in subsection (2), shall be added. . . If a taxpayer subject to a penalty under this subsection demonstrates to the satisfaction of the department that the deficiency or excess claim for credit was due to reasonable cause, the department shall waive the penalty.

Guidance for waiver of a negligence penalty is found in the administrative rules at R205.1012 which provides:

> Rule 12. (1) Negligence is the lack of due care in failing to do what a reasonable and ordinarily prudent person would have done under the particular circumstances. The standard for determining negligence is whether the taxpayer exercised ordinary care and prudence in preparing and filing a return and paying the applicable tax in accordance with the statute. The facts and circumstances of each case will be considered.
>
> (2) When the department imposes a negligence penalty, the department bears the burden of establishing facts to support a finding of negligence and the taxpayer bears the burden of establishing facts that will negate a finding of negligence. The taxpayer shall file a written statement that explains, in detail, the facts which are relied upon to defeat the penalty and which constitute reasonable cause.

The facts in this case are clear that Petitioner failed to maintain detailed, comprehensive and orderly records of its business enterprise as required by statute and administrative rule. Petitioner's disregard for the law caused unnecessary delays in the audit, as well as forcing Respondent's auditor to employ an audit methodology that, by its very nature, is less than ideal. As such, the Tribunal finds that Petitioner was negligent and the penalty imposed by Respondent stands.

JUDGMENT

IT IS ORDERED that Assessment No. N071558 is AFFIRMED, including accrued interest and 10% negligence penalty as follows:

Tax	$95,718.00
Penalty	$ 9,573.00
Interest *	$ *
Total	$105,291.00*

*Interest accruing and to be computed in accordance with Sections 23 and 24 of 1941 PA 122.

This Opinion and Judgment resolves all pending claims in this matter and closes this case.

MICHIGAN TAX TRIBUNAL

Entered: April 13, 2010 By: Cynthia J Knoll