DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 99-0462
STATE GROSS RETAIL TAX
For the 1996, 1997, and 1998 Tax Years

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ISSUES

I. Calculation of Taxpayer's Gross Retail Tax Liability Based Upon the Best Information Available.

Authority: IC 6-8.1-5-1(a); IC 6-8.1-5-1(b); 45 IAC 2.2-6-8(a).

Taxpayer protests the audit's determination, based upon a "best information available" assessment, that taxpayer is liable for a certain amount of unpaid gross retail (sales) tax. Taxpayer argues that, based upon more recent sales figures, it is possible determine a more accurate – and lesser – sales tax liability.

II. Request for Abatement of the Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-5-1(b); IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-(c).

The taxpayer has asked the Department to exercise its discretion to abate the ten-percent negligence penalty. Taxpayer maintains that its failure to retain complete financial records was a simple oversight made by an inexperienced businessperson.

STATEMENT OF FACTS

Taxpayer owns two taverns both of which are essentially bar and liquor stores. The taverns also market food and certain related items. One of the taverns sells enough food to entitle it to a Sunday liquor license. During the tax years 1996, 1997, and 1998, the taxpayer failed to keep cash receipts or other information documenting the sales at either of the establishments. The audit assessed sales tax based upon the best information available. Audit compared the taxpayer's reported cost of goods sold and the taxpayer's reported taxable sales with a published source, Dr. Leo Troy, ALMANAC OF INDUSTRIAL AND FINANCIAL RATIOS (29th ed. 1998), but determined that the result was unrealistically

high. Instead the audit calculated taxpayer's sales by determining the taxpayer's cost of goods sold and "grossing up, the figure by a factor of two. The Department's past practice, in previous cases with similar facts, was to utilize a factor between 2 and 7. In taxpayer's situation, the audit decided that the facts did not justify using a factor other than two.

DISCUSSION

I. Calculation of Taxpayer's Sales and Use Tax Liability Based Upon the Best Information Available.

Taxpayer protests the determination of its sales tax liability for 1996, 1997, and 1998 because it claims that the "percentages do not accurately reflect of the operations of [taxpayer]." Taxpayer Letter, March 1, 2001, p. 1. Among other reasons, the taxpayer claims that the audit determination does not take into account a realistic apportionment between the taxpayer's bar sales and package liquor sales and the variance in the profit margins of the two taverns. Taxpayer further claims that the audit's determination does not account for certain variables such as "local economic conditions, location, patron demographics, and market pressures." Id. at p. 2. Taxpayer does not claim that it is able to assemble actual records for the years at issue. Instead, taxpayer presents a competing estimate of its taxable sales for 1996 through 1998. Taxpayer arrives at this estimate by extrapolating backwards from those years in which complete sales records are available. Taxpayer used a 21-month period, between April 1999 and December 2000, as a base period in which to calculate its taxable sales for 1996, 1997, and 1998. Taxpayer maintains that there is no reason to believe that there has been a substantive change of the ratio of sales to cost of sales between the tax years at issue and the taxpayer's 21-month base period.

Taxpayer utilized the following procedure to calculate its estimated sales tax liability. Taxpayer summarized cash register receipts ("Z" tapes) by categories including bar sales, package goods, food, and miscellaneous sales. Id. at 2. This summary of sales was compared with taxpayer's purchases made during the same 21-month time period. The comparison between sales and actual purchases resulted in a "mark-up" factor of 1.52 for tavern one and a mark-up factor of 2.10 for tavern two. Taking into account the fact that tavern one's sales exceed that of tavern two by a factor of 2.5, the taxpayer reached a combined mark-up factor of 1.65 for the two establishments.

In addition, the taxpayer has submitted information relating to the applicability of a "shrinkage" factor in determining the its sales tax liability. Taxpayer Letter, March 1, 2001, p. 3; Taxpayer Facsimile, March 7, 2001. Taxpayer maintains that, due to the nature of its business, a certain amount of loss can be attributed to employee dishonesty. Taxpayer maintains that "cost of shrinkage" must be removed from any initial calculation of its sales to reflect the true cost of sales. Based upon the taxpayer's research, the "cost of shrinkage" can be reasonably calculated at between 23% for hard liquor and draft

sales, 10% for wine sales, and 2% on bottled beer. Taxpayer has estimated its own shrinkage at 15% and has applied that figure in arriving at an estimate of its taxable sales.

45 IAC 2.2-6-8(a) states that "[i]n determining the retail merchants' tax liability for a particular reporting period, the retail merchant shall multiply the retail merchant's total gross retail income from taxable transactions made during period . . . ." The rule is straightforward but complicated by the fact that records of the taxpayer's "taxable transactions" do not exist. In those situations in which the taxpayer has not maintained adequate records, the Department is authorized to reach an assessment based upon the best information available. IC 6-8.1-5-1(a) states that "[i]f the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the *best information available*." (Emphasis added). The Department made such an assessment by considering published information, the records provided by the taxpayer, and the Department's own past practices. The audit considered those factors, discarded the unrealistically high initial result, and eventually adopted a multiplier of two.

The initial audit determination of taxpayer's liabilities arrives with a presumption of correctness. IC 6-8.1-5-1(b) states that "[t]he notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." As the "person against whom the proposed assessment [was] made," taxpayer has met its burden of submitting information – based upon adequately maintained financial records – which raises the question of whether audit's determination most accurately reflects taxpayer's taxable sales. Taxpayer has provided - for the 21-month base period - original cash register receipts, monthly summaries of those receipts, and workpapers which purport to establish the reliability of the taxpayer's proposed 1.65 multiplier and its consequent sales tax liability.

However, taxpayer's request to include a "shrinkage factor" in the final calculation of its sales tax liability is unwarranted. Taxpayer's argument fails for two reasons. First, losses based on inventory shrinkage are highly variable, dependent on the unique circumstances of each individual business, and difficult to determine with any reasonable degree of certainty. Second, taxpayer is asking the Department to approve a method of determining its past sales in which the "shrinkage factor" is already an inherent component. Taxpayer asks the Department to adopt a 1.65 multiplier in calculating the taxpayer's sales. This means that, in those years in which taxpayer failed to maintain adequate records, for every $100 in goods taxpayer purchased, the taxpayer will be assessed tax on $165 in sales. Whatever shrinkage or other losses the taxpayer may have experienced occurred between the time taxpayer purchased the $100 in goods and sold those goods for $165. The inventory shrinkage is already an essential component in that final sales calculation. Whether taxpayer experienced 1%, 50%, or 99% in inventory shrinkage, taxpayer purchased $100 in goods and then sold those same goods – minus whatever losses were incurred – for $165. Audit may review taxpayer's records and find that the 1.65 multiplier is entirely reasonable, but taxpayer is not entitled to piggy-back an additional "shrinkage factor" on that multiplier.

The audit division is requested to perform a supplemental audit to verify the reliability and factual basis of the taxpayer's proposed determination of its sales tax liability.

FINDING

Subject to the results of the supplemental audit, taxpayer's protest is sustained.

II. Request for Abatement of the Ten-Percent Negligence Penalty.

The taxpayer has requested that the ten-percent negligence penalty, assessed by audit under authority of IC 6-8.1-10-2.1, be abated. The Department's regulations provide guidance in determining those instances in which imposition of the ten-percent negligence penalty is appropriate. 45 IAC 15-11-2(b) defines negligence as "the failure to use reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." The taxpayer's negligence may be inferred from its "carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations." Id. IC 6-8.1-10-2.1(d) requires that the Department waive the penalty upon a showing that the taxpayer's failure to pay the tax delinquency was due to "reasonable cause and not due to willful neglect." In order to establish "reasonable cause," 45 IAC 15-11-2(c) requires that the taxpayer demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Taxpayer maintains that its failure to retain accurate sales records was the result of an erroneous decision of a novice, unsophisticated businessperson. Further, the taxpayer argues that any mistakes it made were due to unfamiliarity with its responsibilities under the relevant tax code and not due to willful neglect.

The taxpayer has failed to set forth a basis for establishing that it exercised the degree of care statutorily imposed upon an ordinarily reasonable taxpayer. Taxpayer's assertion, requesting that the penalty be abated based upon the taxpayer's own naivete, is insufficient to overcome the presumption of correctness afforded the audit's determination under IC 6-8.1-5-1(b). 45 IAC 15-11-2(b) states that "[i]gnorance of the listed tax laws, rules and/or regulations is treated as negligence."

FINDING

Taxpayer's protest is respectfully denied.