DEPARTMENT OF STATE REVENUE

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Letter of Findings: 07-0467
Sales and Use Tax
For the Years 2004, 2005, 2006

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ISSUES

I. Sales Tax – Cost of Goods Sold.

Authority: IC § 6-2.5-2-1; IC § 6-8.1-5-1; IC § 6-8.1-5-4.

Taxpayer protests the method used by the Department to estimate the assessment in the absence of records.

II. Use Tax – Imposition.

Authority: IC § 6-8.1-5-1; IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-1-27; *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests the imposition of use tax on certain items.

III. Tax Administration – Imposition of Negligence Penalty.

Authority: IC § 6-8.1-5-1; IC § 6-8.1-5-4; IC § 6- 8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of a ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a tavern located in Indiana. Taxpayer is organized as a subchapter S corporation. Taxpayer serves food and has a three-way liquor license. Indiana income taxes are reported on Form IT-20S and federal income taxes are reported on Federal Form 1120S.

The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of Taxpayer for the years 2004, 2005, and 2006. Taxpayer was assessed additional sales and use tax pursuant to the audit. Taxpayer protested the assessment of sales and use tax. A hearing was held and this Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales Tax – Cost of Goods Sold.

DISCUSSION

Taxpayer protests the particular Cost of Goods Sold percentage that the Department used in arriving at gross sales.

Indiana imposes a sales tax on retail transactions made in Indiana. IC § 6-2.5-2-1(a). The person who acquires property in a retail transaction is liable for the tax on the transaction and, unless exempt, shall pay the tax to the retail merchant. The retail merchant shall collect the tax as agent for the state. IC § 6-2.5-2-1(b). If 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 to the department. IC § 6-8.1-5-1(a). Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. IC § 6-8.1-5-4 (a). A person must allow inspection of the books and records and returns by the department or its authorized agents at all reasonable times. IC § 6-8.1-5-4 (c). The 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. IC § 6-8.1-5-1(c).

During the audit Taxpayer's records were reviewed for the years in question. According to the Department's audit report, the sales records presented for review consisted of weekly sales sheets completed by Taxpayer and bank statements. No cash register tapes, guest checks or other source documents were available to verify sales. Because the source documents were not available, a comparison was made between total bank deposits and reported sales. This method proved unreliable in verifying sales because the amounts deposited in the bank were less than the reported sales. In the absence of reliable records substantiating sales, the Department utilized an alternative method of estimating sales based on Taxpayer's reported cost of goods sold to arrive at a reasonable sales amount.

According to the Department's audit report, the Taxpayer's cost of goods sold represented 47.1% of its reported sales in 2004, 43.5% in 2005, and 43.4% in 2006. However, data on the BizStats.com (a web site that has average profitability and expense percentages for U.S. small businesses in several categories) indicated that cost of goods sold should average 42.5% of sales. Based on this information, Taxpayer's cost of goods sold was divided by 42.5% to arrive at what Department attributed as Taxpayer's sales. The sales Taxpayer reported were then deducted from the sales the Department attributed to Taxpayer to arrive at the additional sales upon which Taxpayer was assessed sales tax.

Taxpayer argues that its percentages, as reported above by the Department's audit report, or those of another data provider whose percentage is more in line with Taxpayer's percentages, should be used to arrive at attributed sales.

Taxpayer provides several explanations as to why the BizStat 42.5% cost of goods sold percentage should not be applied in calculating its taxable sales. Taxpayer believes that the drop in its profitability in 2004 is due to the arrival of a competitor located at a nearby golf course that ran daily specials on beer prices which forced Taxpayer to do the same. Thus, the lower gross sales number for that year, Taxpayer argues, is reasonable. However, in its August 14, 2007, protest letter Taxpayer states that its 2003 cost of goods sold was 46.9% which it says is consistent with the 2004 number – this consistency of numbers between 2003 and 2004 argument belies the explanation that in 2004 Taxpayer's profitability dropped due to the arrival of a competitor.

Also, Taxpayer argues that its carryout sales are at cost or close to cost as a strategy for attracting sit-in business and to comport with the pricing of its local competitors. Taxpayer did not separately track its carryout sales until after the audit. Taxpayer, however, calculated its carryout sales for the last nine months of 2007 as a percentage of its total sales. Taxpayer then applied this percentage to the audit years to come up with an estimate of carryout sales versus in-house sales. Taxpayer then applied its own listing of carryout prices versus cost to come up with its average of cost of goods sold percentage on those sales. Taxpayer then subtracted carryout cost of goods sold from total cost of goods sold and applied a percentage to the difference to gross up for cost of goods sold.

Taxpayer failed to keep complete records as required by IC § 6-8.1-5-4(a). Due to the lack of complete records, the Department, pursuant to IC § 6-8.1-5-1(a), made an assessment of unpaid tax based on the best information available to it. The statistics the Department relied on represent industry averages for a particular region. The industry averages reflect business practices of a particular industry, which incorporate the standard types of pricing strategies Taxpayer describes. Taxpayer's use of 2007 numbers remains theoretical without further substantiation of actual numbers for the years in question. Therefore, since the Department's reliance on BizStats is reasonable and based on the best information available to it, its assessment stands.

Taxpayer further protested that certain items should not be included in the cost of goods sold calculations. In support of its arguments, Taxpayer points to certain items on certain pages of its general ledger, however Taxpayer, apart from its say-so, insufficiently documented the nature of these items.

Taxpayer has not established that its method is superior to the Department's method. The Department notes that the most certain way to establish cost of goods sold and taxable sales is to keep accurate records. Taxpayer has not met its burden of proof to sustain its protest.

FINDING

Taxpayer's protest is respectfully denied.

II. Use Tax – Imposition.

DISCUSSION

Taxpayer argues that certain items should be removed from the Department's use tax calculation.

All tax assessments are prima facie evidence that the Department's claim for the tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Indiana imposes a sales tax on retail transactions and a complementary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-2-1 and IC § 6-2.5-3-2. An exemption from the use tax is granted for transactions where the gross retail tax ("sales tax") was paid at the time of purchase pursuant to IC § 6-2.5-3-4.

IC § 6-2.5-2-1 provides:

(a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.

(b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

IC § 6-2.5-3-2(a) provides:

An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction.

IC 6-2.5-3-4 provides:

(a) The storage, use, and consumption of tangible personal property in Indiana is exempt from the use tax if:

(1) the property was acquired in a retail transaction in Indiana and the state gross retail tax has been paid on the acquisition of that property; or

(2) the property was acquired in a transaction that is wholly or partially exempt from the state gross retail tax under any part of IC 6-2.5-5, except IC 6-2.5-5-24(b), and the property is being used, stored, or consumed for the purpose for which it was exempted.

(b) If a person issues a state gross retail or use tax exemption certificate for the acquisition of tangible personal property and subsequently uses, stores, or consumes that property for a nonexempt purpose, then

the person shall pay the use tax.

A. BMI Music License

Taxpayer protests that a music license fee it pays to BMI (Broadcast Music, Inc.) is not tangible personal property subject to sales or use tax.

IC § 6-2.5-1-27 defines tangible personal property:

"Tangible personal property" means personal property that:

(1) can be seen, weighed, measured, felt, or touched; or

(2) is in any other manner perceptible to the senses.

The term includes electricity, water, gas, steam, and prewritten computer software.

The BMI website (http://www.bmi.com/) describes the license Taxpayer refers to as a "Music Performance Agreement" that allows a business such as Taxpayer's to "perform" musical compositions the performance of which, absent such an agreement, is, by copyright law, the exclusive right of their creators. This license agreement, therefore, is not tangible personal property as defined by IC § 6-2.5-1-27 and not subject to sales or use tax.

B. Bar Stools

The Department's audit report shows a use tax assessment for bar stools invoiced on 8/1/2004 for $193.60. Taxpayer states that "this was picked up by the auditor from a Discover bill [and] [r]epresents a previous balance on the card that was paid with a personal check which was a personal purchase and not expensed through the business." At the hearing Taxpayer presented the relevant ledger to show that there was no $193 charge for the business. After the hearing Taxpayer presented a copy of the cancelled check for that amount on its shareholder's personal bank account. Taxpayer has met its burden to show that *it* does not owe use tax on the purchase of the bar stools because the bar stools were not purchased for use by Taxpayer.

Taxpayer's August 14, 2007, letter protests two additional items under the use tax portion of the Department's audit assessment. However, at hearing, Taxpayer conceded those two items.

FINDING

Taxpayer's protest is sustained.

III. Tax Administration – Imposition of Negligence Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalty for the tax years in question. Taxpayer protests the imposition of penalty. The Department refers to IC § 6- 8.1-10-2.1(a)(3), which provides, "if a person... incurs, upon examination by the department, a deficiency that is due to negligence... the person is subject to a penalty."

The Department refers to 45 IAC 15-11-2(b), which states:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive the negligence penalty as provided in 45 IAC 15-11-2(c), as follows:

> The department shall waive the negligence penalty imposed under IC § 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must 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 under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
>
> (1) the nature of the tax involved;
>
> (2) judicial precedents set by Indiana courts;
>
> (3) judicial precedents established in jurisdictions outside Indiana;
>
> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
>
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
>
> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

In this case, Taxpayer incurred a deficiency which the Department determined was due to negligence under 45 IAC 15-11-2(b), and was subject to a penalty under IC § 6-8.1-10-2.1(a).

Under IC § 6-8.1-5-1(b), "the burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Taxpayer is under a legal obligation to maintain its books and records in such a manner that the Department can determine the amount, if any, of Taxpayer's tax liabilities by

reviewing those books and records. IC § 6-8.1-5-4(a). Taxpayer has not affirmatively established that its failure to maintain its books and records or pay the deficiencies was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is respectfully denied.

CONCLUSION

Taxpayer's protest of sales tax assessed is denied.
Taxpayer's protest of use tax assessed is sustained.
Taxpayer's protest of the assessment of negligence penalty is denied.

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