DEPARTMENT OF STATE REVENUE

04-20170082.LOF

Letter of Findings: 04-20170082
Sales and Use Tax
For the Years 2013, 2014, and 2015

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Contradicting its well-established point of sale ("POS") software system and its own written - "All Sales Final No Refunds" - return policy, Indiana Retailer manually refunded cash to its customers regardless of their payment methods without properly documenting the refund transactions. In the absence of verifiable records to support that it refunded the sales tax to the person from whom it collected the tax, Indiana Retailer was responsible for the additional sales tax on the returned merchandise.

ISSUES

I. Sales & Use Tax - Imposition.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-1-27; IC § 6-2.5-2-1; IC § 6-2.5-3-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-4-1; IC § 6-2.5-5-1 *et seq.*; IC § 6-2.5-6-14.1; IC § 6-2.5-9-3; IC § 6-2.5-13-1; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Rhoade v. Indiana Dep't of State Revenue*, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); *USAir, Inc. v. Indiana Dep't of State Revenue*, 623 N.E.2d 466 (Ind. Tax. Ct. 1993); *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); 45 IAC 2.2-2-1; 45 IAC 2.2-3-14; 45 IAC 2.2-8-12.

Taxpayer protests the assessment of sales tax and use tax, claiming that the assessment is overstated.

II. Tax Administration - Negligence Penalty.

Authority: 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 single-member limited liability company (LLC); its sole member ("Owner") manages Taxpayer's store selling tobacco and smoking accessories in Indiana. In addition to tobacco products, such as pipes, cigars, and E-cigarette products, Taxpayer also sells hookahs, vaporizers, toxin removers, clothing, flasks, and jewelry. Taxpayer files the sales tax returns (ST-103 forms), reporting the Indiana sales tax monthly. Taxpayer's profits and losses are reported through the Schedule C on Owner's federal individual income tax returns.

In 2016, the Indiana Department of Revenue ("Department") audited Taxpayer's business records for the 2013, 2014, and 2015 tax years ("Tax Years at Issue"). Pursuant to the audit, the Department found that Taxpayer did not maintain adequate records and source documents in reporting its sales tax returns and remitting the sales tax. The audit also found that Taxpayer purchased tangible personal property without paying sales tax or self-assessing use tax. In light of the inadequate business records and documentation, the Department assessed additional sales tax, use tax, interest, and penalty.

Taxpayer protested the assessment. A hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results. Additional facts will be provided as necessary.

I. Sales & Use Tax - Imposition.

DISCUSSION

Pursuant to the audit, the Department assessed additional sales tax because Taxpayer had underreported its sales for the Tax Years at Issue. Specifically, the audit first found that Taxpayer made calculation errors when it filed its sales tax returns. The audit also found that Taxpayer had failed to maintain adequate records to support its refund of sales tax to its customers on the returned purchases. Despite Taxpayer's own written return policy stating "All Sales Final No Refunds," the audit found that Taxpayer refunded cash to every customer who returned their purchases regardless of their initial payment methods at the time of their purchases. Without adequate and verifiable documents to substantiate the refund of sales tax, the audit disallowed Taxpayer's subtraction of the total amount of the sales tax with respect to these returned items from the total amount of the sales tax reported for the Tax Years at Issue. The audit further found that Taxpayer purchased several items which were used during the course of its business without paying sales tax at the time of purchase or later remitting the use tax on those purchases when Taxpayer used them in Indiana.

Taxpayer, to the contrary, argued that the audit assessment is overstated. Taxpayer stated that it was not responsible for the sales tax on the returned merchandise. Taxpayer further claimed that it was not responsible for several purchases because they were Owner's personal purchases which were not charged to Taxpayer's expense account or because the purchases were not subject to sales tax.

As a threshold issue, all tax assessments are *prima facie* evidence that the Department's claim for the unpaid 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 Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012). Thus, the taxpayer is required to provide documentation explaining and supporting its challenge that the Department's assessment is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). IC § 6-8.1-5-4(a) further provides:

> 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. **The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks**. (**Emphasis added**).

The taxpayer "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). "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(b). Thus, the issue is whether Taxpayer provided sufficient supporting documentation to demonstrate that the Department's proposed assessment – additional sales tax and use tax – is not correct.

In this instance, Taxpayer claimed that the audit assessment was overstated. Taxpayer did not dispute that it made calculation errors when it filed the returns reporting its gross sales for the Tax Years at Issue. Taxpayer also did not dispute that use tax was due on some of its purchases. Rather, Taxpayer argued that the audit assessment was overstated because (1) it was not responsible for the additional sales tax on the returned merchandise, and (2) it was not responsible for the use tax on payments that were Owner's personal expenses. This Letter of Findings addresses the issues, in turn, as follows:

A. Disallowance of Sales Tax on Returned Merchandise

The tax in question stemmed from the sales tax which Taxpayer claimed it refunded to its customers when they returned their purchases. Taxpayer subtracted the amount of sales tax in question when it filed the monthly sales tax returns for the Tax Years at Issue. The Department's audit disallowed the total amount of the sales tax in that regard which resulted in additional sales tax due. Taxpayer argued that it was not responsible for the sales tax refunded to its customers.

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a); 45 IAC 2.2-2-1. A retail transaction is a transaction made by a retail merchant that constitutes "selling at retail." IC § 6-2.5-1-2(a). Selling at retail occurs when a person "(1) acquires tangible personal property for the purpose of resale; and (2) transfers that property to another person for consideration." IC

§ 6-2.5-4-1(b). "Tangible personal property," as defined in IC § 6-2.5-1-27, "means personal property that: (1) can be seen, weighed, measured, felt, or touched; or (2) is in any other manner perceptible to the senses," including "electricity, water, gas, steam, and prewritten computer software." A person who acquires tangible personal property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b). A retail sale is sourced to Indiana and therefore is subject to Indiana sales tax when the transaction is a "retail sale . . . of a product" and "the product is received by the purchaser at a business location of the seller [in Indiana] . . . ." IC § 6-2.5-13-1(d)(1). The purchaser in general "shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction." *Id*. "The retail merchant shall collect the tax as agent for the state." *Id*. Otherwise, as an agent for the State of Indiana, the seller "holds those taxes in trust for the state and is personally liable for the payment of those taxes, plus any penalties and interest attributable to those taxes, to the state." IC § 6-2.5-9-3.

Because the retail merchant - the agent for the state - is required to collect and remit the sales tax, a trust tax, on the retail transaction from the purchaser, the retail merchant is often tasked with customer's requests of refund when the customers return their purchases subsequently after the retail transactions. Under those circumstances, IC § 6-2.5-6-14.1 specifically explains that the "**retail merchant is not entitled to a refund of state gross retail [tax] . . . unless the retail merchant refunds those taxes to the person from whom they were collected**." (**Emphasis added**). In other words, when the retail merchant indeed refunds the sales tax, which it previously collected, to its customer, the retail merchant may be entitled to the refund of sales tax from the state.

In this instance, despite Taxpayer's own written return policy stating "All Sales Final No Refunds," the audit found that Taxpayer refunded cash - without using its POS system - to every customer who returned the purchase regardless of the customer's initial payment methods at the time of the sale. The audit also found that Taxpayer did not maintain verifiable records for these refunds of the sales tax in question. Without adequate and verifiable documents, the audit disallowed Taxpayer's subtraction of the total amount of the sales concerning the returned items as a result. In relevant part the audit noted:

> Gross sales calculation error
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> The auditor reviewed the taxpayer's Z-tapes [i.e., cash register tapes] and concluded that the POS system is materially correct in recording daily sales. However, due to inadequate record keeping, the taxpayer miscalculated gross sales that were submitted on the ST-103 sales tax return[s]. . . .
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> Returns
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> In each of the audit years, the taxpayer claimed 23[percent]-25[percent] of gross sales were returned and refunded to the customer. Regardless of the original form of payment, the taxpayer claims the selling price and sales tax was refunded to the customers in cash. These returns were not processed through the point of sale system. The taxpayer manually deducted these returns from the total gross sales monthly to arrive at the taxable sales reported on the ST-103 [forms]. The auditor was provided a handwritten notebook log to support the 2013-2015 return transactions. The documentation lacked correlated details to support the return transaction activity, such as original receipt date or number. The auditor requested and the taxpayer neglected to supply the requested three months of original sales receipts for each year in the audit period. **The taxpayer provided one month of each year in the audit period (January 2013, March 2014, [and] November 2015) of original sales receipts to support the handwritten return log as representative of the audit period. However, original sales receipts for calendar year 2016 were provided which was not in the audit period. All sales receipts indicate the taxpayer's return policy as "All Sales Final No Refunds." The auditor's inquiry of the No Refund policy was explained that the taxpayer does not adhere to the policy clearly stated on the final sales receipts. In the auditor's review of the original sales receipts and corresponding return transactions, it was noticed that several return transactions did not coincide with the original transaction date** . . . . (**Emphasis added**).

Throughout the protest process, Taxpayer claimed that it was not responsible for the sales tax in question because "there is no retail transaction." In relevant part, Taxpayer stated:

> When [Taxpayer] refunds a customer the amount the customer paid for merchandise they purchased from [Taxpayer] subsequent to the refund, there is no retail transaction completed. [Taxpayer] did not transfer any property to the customer and the customer did not give any consideration to [Taxpayer] in exchange for tangible personal property. The [D]epartment . . . has assessed sales tax on refund transactions where there is no retail transaction, nor are there any gross receipts.

> The [D]epartment appears to be enforcing [Taxpayer] return policy and stating then that there must not have been a refund of the gross receipts. [Taxpayer] has stated that employees or members of [Taxpayer] refunded the amount of the sale and the sales tax collected that were noted on the return logs used to prepare the sales tax returns . . . . Taxpayer believes that [it is] entitled to deduct any sale amounts where the sale price was refunded in exchange for the returned merchandise in arriving at their gross retail receipts subject to sales tax because there was no transfer of property, nor was there any consideration paid. . . .

Subsequently after the hearing, to support its protest, Taxpayer submitted copies of its "November 2015 Returns" log ("Log") and relevant copies of the reprinted "Sales Receipt" concerning the refund items listed in the Log.

Upon review, however, Taxpayer is mistaken. There is no dispute that Taxpayer has used its POS system to record all of its sales for the Tax Years at Issue. Through Taxpayer's well-established POS system, its "Sales Receipt" captured information, in detail, of the sales for the Tax Years at Issue. The information included, but not limited to, "Sales Receipt [Number]," Date of Sale, "Item [Number]," "Description" of each item sold, "Price" of each item sold, discount, "Price" of total sales, payment method, and a separately stated "Sales Tax" amount. Thus, Taxpayer's records showed that, at the time of the retail transactions, consideration was given and these sales were Indiana retail transactions subject to Indiana sales tax. Taxpayer's "Sales Receipt," emphasizing "All Sales Final No Refunds," further gave its customers adequate notice at the time of the sales when the customers took the possession of the items. The customers were fully aware that refunds would not have been allowed after the transactions because "All Sales [are] Final." Thus, at the conclusion of the sales, Taxpayer held the sales tax it collected in trust for the state. Taxpayer, as the agent for the state, was required to remit the sales tax it collected; otherwise, it was personally liable for the amount of tax due. IC § 6-2.5-9-3.

Subsequently after the sales, Taxpayer contradicted its "No Refunds" policy and manually refunded "cash" to its customers regardless of their initial payment methods. Taxpayer's Log demonstrated that Owner or employees manually recorded only the following information: (1) item number, (2) item description, and (3) the total amount of each item which it claimed was refunded. The Log did not reference the original sales. The Log also failed to capture the contemporaneously essential information, including the time of the refund, to whom it issued the refund, and the separate amount of the sales tax refunded as required by IC § 6-2.5-6-14.1. Further, Taxpayer did not obtain any verification from its customers, from whom the taxes were collected, to support each of its refunds. Nor did Taxpayer maintain its inventory records or document its subsequent actions after these refunds concerning the returned items in question as any prudent retail merchant would have done to mitigate its losses.

As mentioned earlier, Taxpayer is the agent for the state and is reminded that sales tax becomes due at the time of the transactions. When Taxpayer allowed its customers to return their purchases for whatever reason - regardless of its written "No Refunds" policy - subsequently after the sales and it refunded the amount they paid (including sales tax) on the returned items, these cash refunds in question should have been refunded using its well-established POS system or similar verifiable procedure to properly document the refund transactions. Taxpayer was required to demonstrate that it refunded the sales tax to the person from whom the tax was collected pursuant to IC § 6-2.5-6-14.1 and IC § 6-8.1-5-4 before it was entitled to the refund of the sales tax it previously collected.

Taxpayer, however, failed to do that. Specifically, the audit noted that Taxpayer offered several reprinted "Sales Receipts," which were transactions that occurred after Taxpayer had claimed the refunds in its Log. In other words, Taxpayer's documentation suggested that it refunded money to some unknown customers first before these unknown customers made their future purchases. A further review of the reprinted "Sales Receipt" and the Log also showed that Owner manually recorded information which failed to correspond to the return items in question. For example, Taxpayer's reprinted "Sales Receipt [] 282706" consisted of two items (Numbers "7363" and "8633") sold on 11/12/2015, for $40.11 (including sales tax of $2.62) total. However, its Log claimed that it refunded the same Item "7363" for "$28.09" and Item "8633" for "$16.04"–the total refund of $44.13. Assuming that the customer purchased the same two items at the same transaction and subsequently returned both items at the same transaction, Taxpayer in this instance, would have refunded more than it previously collected at the time of that sale transaction as a result. Unlike its POS system that captured integrity of the sales, including separately stated sales tax, Taxpayer's Log failed in that regard. Therefore, Taxpayer's reliance on its Log and reprinted Sales Receipts is misplaced. To state it differently, if the purchasers indeed returned the items they previously purchased to Taxpayer for the full refunds, the refunds should be properly processed in a consistent manner at the time the refund transactions occurred; otherwise the burden of proving the refund transactions, especially a refund in cash to a unknown person, becomes measurably more difficult.

In short, without verifiable documentation to support that Taxpayer refunded the correct amount of sales tax to the person from whom the tax was collected, the audit properly disallowed the amount that Taxpayer refunded to its

unknown customers and Taxpayer is responsible for the sales tax in question pursuant to the above mentioned Indiana law.

B. Use Tax on Owner's Personal Purchases

The Department assessed use tax on various items which Taxpayer purchased and used for its business during the Tax Years at Issue without paying sales tax or self-assessing use tax. Taxpayer claimed that the audit erroneously assessed use tax on some of Owner's personal purchases, which were not deducted in the Schedule C. Taxpayer also asserted that some purchases were non-taxable services.

In addition to sales tax, Indiana imposes a complementary excise tax called "the use tax" 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 § 6-2.5-3-2(a). "Use" means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a). The use tax is generally functionally equivalent to the sales tax. *See Rhoade v. Indiana Dep't of State Revenue*, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

By complementing the sales tax, the use tax ensures that non-exempt retail transactions (particularly out-of-state retail transactions) that escape sales tax liability are nevertheless taxed. *Rhoade*, 774 N.E.2d at 1048; *USAir, Inc. v. Indiana Dep't of State Revenue*, 623 N.E.2d 466, 468 - 69 (Ind. Tax. Ct. 1993). The use tax ensures that, after such goods arrive in Indiana, the retail purchasers of the goods bear their fair share of the tax burden. *Rhoade*, 774 N.E.2d at 1050. To trigger imposition of Indiana's use tax, tangible personal property must (as a threshold matter) be acquired in a retail transaction. IC § 6-2.5-3-2(a); *USAir, Inc.*, 623 N.E.2d at 468 - 69. A taxable retail transaction occurs when (1) a party acquires tangible personal property as part of its ordinary business for the purpose of reselling the property; (2) that property is then exchanged between parties for consideration; and (3) the property is used in Indiana. *See* IC § 6-2.5-1-2; IC § 6-2.5-4-1(b) and (c); IC § 6-2.5-3-2(a).

An exemption from the use tax is granted for transactions where the sales tax was paid at the time of purchase pursuant to IC § 6-2.5-3-4 and 45 IAC 2.2-3-14. Other statutory exemptions afforded under IC § 6-2.5-5-1 *et seq.* may also apply. A statute which provides a tax exemption, however, is strictly construed against the taxpayer. *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 97 (Ind. Ct. App. 1974). "[W]here such an exemption is claimed, the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Id.* at 101 (citing *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (Ind. 1877)).

In this instance, Taxpayer argued that several items listed in the audit report were Owner's personal purchases and were not deducted on the Schedule C. Taxpayer also asserted that some purchases were non-taxable services.

Upon review, however, the Department is not able to agree. Specifically, Taxpayer simply marked those items at issue and its objection in the audit report without providing the source documents. Taxpayer offered a summary of its Bank Statement Deposits to support its protest, but the summary is not the source documents. The audit noted that Taxpayer did not have receipts regarding those purchases which were paid through Taxpayer's bank accounts. Thus, give the totality of the circumstances, in the absence of other verifiable supporting documentation, the Department is not able to agree that Taxpayer met its burden to demonstrate that the Department's proposed assessment is not correct.

FINDING

For the reasons discussed above, Taxpayer's protest of the Department's proposed assessment of additional sales tax is denied. Taxpayer's protest of the Department's proposed assessment of additional use tax is also denied.

II. Tax Administration - Negligence Penalty.

DISCUSSION

Taxpayer also protested the imposition of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1(a), the Department may assess a ten (10) percent negligence penalty if the taxpayer:

(1) fails to file a return for any of the listed taxes;
(2) fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment;
(3) incurs, upon examination by the department, a deficiency that is due to negligence;
(4) fails to timely remit any tax held in trust for the state; or
(5) is required to make a payment by electronic funds transfer (as defined in IC 4-8.1-2-7), overnight courier, or personal delivery and the payment is not received by the department by the due date in funds acceptable to the department.

45 IAC 15-11-2(b) further 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 a negligence penalty as provided in 45 IAC 15-11-2(c), in part, 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:
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> (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.
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> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer did not provide sufficient documentation establishing that its failure to pay tax or timely remit tax was due to reasonable cause and not due to negligence.

FINDING

Taxpayer's protest on the imposition of the negligence penalty is denied.

SUMMARY

For the reasons discussed above, under Issue I, Taxpayer's protest of the Department's proposed assessment of additional sales tax and use tax is denied. Taxpayer's protest of Issue II, the negligence penalty, is also denied.

Posted: 02/28/2018 by Legislative Services Agency
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