

STATE OF MICHIGAN
DEPARTMENT OF LICENSING & REGULATORY AFFAIRS
MICHIGAN ADMINISTRATIVE HEARING SYSTEM
MICHIGAN TAX TRIBUNAL

SMK, LLC,
Petitioner,

MTT Docket No. 409504
Assessment No. R848672

v

Michigan Department of Treasury,
Respondent.

Tribunal Judge Presiding
Cynthia J Knoll

FINAL OPINION AND JUDGMENT

INTRODUCTION

SMK, LLC, (Petitioner) appeals an assessment issued by the Michigan Department of Treasury (Respondent) of sales tax, plus interest and penalty. A hearing was conducted by the Tribunal on July 27, 2011. The assessment is the result of Respondent's audit which found Petitioner over reported the exempt food deduction. The audit was performed by conducting a sampling of products purchased and applying 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 the assessment was based on imperfect estimates whereas Petitioner's records were accurate and adequate to determine the actual taxable sales. The Tribunal finds that Petitioner has met its burden to refute the prima facie correctness of the assessment, and the assessment is cancelled.

BACKGROUND

Petitioner is a convenience store, meat market and delicatessen doing business under the assumed name "Parkside Market & Deli." It is located in Midland, Michigan, and is owned by Mark Raykovitz ("Mr. Raykovitz"). Respondent conducted a sales tax audit of the period June 1, 2005, through May 31, 2009. Respondent's auditor determined that Petitioner had underpaid sales tax in the amount of \$10,006.00, based on his conclusion that Petitioner had overstated the non-taxable food deduction and therefore understated its taxable sales. Respondent issued an Intent to Assess on April 6, 2010.

On June 15, 2010, Respondent issued Final Bill for Taxes Due (Final Assessment) R848672 for \$10,006.00 tax, \$1,002.00 penalty, and \$2,007.63 interest. On July 29, 2010, Petitioner filed this appeal with the Tax Tribunal, appealing the assessed tax, penalty, and interest. Respondent filed a Motion for Summary Disposition contending that Petitioner failed to file its appeal in a timely fashion. On January 20, 2011, the Tribunal entered an Order denying Respondent's Motion and therefore jurisdiction is not at issue. A hearing was held July 27, 2011.

EXHIBITS

The following exhibits were admitted into evidence:

P1 & P2 SMK, LLC Limited Liability Company Details and Assumed Names, Department of Licensing and Regulatory Affairs (LARA)

R3, p. 1 Intent to Assess R848672

P3, R3, p. 2 Final Bill for Taxes Due (Final Assessment), dated June 15, 2010

P4 Final Audit Determination Letter and, dated March 31, 2010

P3 – 10, R 2, pp. 1 - 7 Audit Summary Worksheets

P11, P14, P17, P20 & P23, R4 - 8 2005-2009 Annual Returns for Sales, Use and Withholding Taxes

P12, P15, P18, P21 & P24 SMK, LLC 2005 – 2009 Sales Year to Date Totals – by Day of Month

P13, P16, P19, P22 & P25 SMK, LLC 2005 – 2009 Monthly Sales Detail – by Day of Month

P26, R1 SMK, LLC Michigan Department of Treasury Audit Report of Findings

P27, R2 pp. 8 - 14 SMK, LLC Sales Tax Audit Work Papers, Detail and Summary Schedules

P30 R205.23 Administrative Rule 23 Records

P32 R205.136 Administrative Rule 86 Food for Human Consumption

P37 Revenue Administrative Bulletin 2005-3 Penalty Provisions

The following exhibits were not admitted into evidence:

P33 Revenue Administrative Bulletin 2009-8 Sales Tax – Food for Human Consumption was not admitted because it is irrelevant as it postdates the audit period in this matter.

P34 and P 35 Audit Sampling Manual – Introduction & Overview, pages 3 – 7 and Time Period Sampling, page 60, Respondent objected as irrelevant because this is not the audit manual for the cash basis type audits.

PETITIONER’S CONTENTIONS:

Petitioner appeals the sales tax assessment based on its contention that it is erroneous in fact and in law. Petition, p. 6. Petitioner contends that the determination was based on a projection from an invalid sample of purchase invoices which reflects poor audit judgment and resulted in an erroneous determination. *Id.* Petitioner contends that the auditor did not audit or review the accounting records and schedules maintained by Petitioner. Petitioner further contends that the auditor projected amounts from purchase invoices without taking into full consideration the various mark-up percentages on different goods sold in the store. Petitioner also asserts that Respondent’s auditor determined the exempt sales percentage without taking into consideration spoilage, damage, employee theft and other factors which preclude inventory purchases from ultimately being sold and subject to sales tax. Petition, p. 3

Petitioner contends that the audit was flawed because the sample used two months of purchases with the results projected over forty-eight months. Petitioner further contends that Respondent’s auditor did not look at sales records, bank statements, cash disbursement journals or cash register tapes. Petitioner’s Prehearing Statement, p. 2. Petitioner contends that it maintains a double entry system of accounting designed to provide reasonable assurance that all sales are reported for accounting and tax purposes. *Id.*

Petitioner contends that it primarily sells food for home consumption, exempt from sales tax. It also sells food for immediate consumption, not exempt. Petitioner asserts that its food deduction during the audit period was as follows:

6/1/2005 through 12/31/2005	46.2389%
1/1/2006 through 12/31/2006	47.0722%
1/1/2007 through 12/31/2007	48.4309%
1/1/2008 through 12/31/2008	46.6883%
1/1/2009 through 5/31/2009	45.8964%

Petition, p. 3. Petitioner contends that all required sales tax returns were properly filed and that it maintained and preserved adequate records, which were made available to the auditor for review.

In support of its contention that sales tax was fully paid and Respondent's audit was flawed, Petitioner called two witnesses. Petitioner's first witness was Petitioner's outside CPA, Scot Smith ("Mr. Smith"), Partner with the Midland accounting firm of Robert F. Murray and Company. Mr. Smith testified that he has worked with Petitioner for about 10 years. He testified as to the demographic location and general layout of the store, the typical age, turnover and experience of employees, the daily management activities by owner, Mr. Raykovitz, and the number and technical capabilities of the cash registers. Mr. Smith testified as to the cash reconciliation and deposit procedures followed by Mr. Raykovitz and the preparation of the monthly sales tax returns and quarterly financial reports by Mr. Smith's firm. Mr. Smith testified that the cash registers are checked and cleaned regularly by the company that sold them to Petitioner. He stated "I'm confident that there are sufficient internal controls in place that the tax is being collected as it should be." See Transcript (Trans), pp. 10 - 24.

Petitioner offered evidence in the form of spreadsheets that were prepared by Mr. Smith's staff. The spreadsheets show daily sales by category including taxable and non-taxable sales. Mr. Smith testified to the schedules and explained how they are reconciled and used for preparing the sales tax returns. He further testified that quarterly compiled financial statements are prepared and analytical procedures are done and reviewed for abnormalities. Mr. Smith testified that Petitioner uses a manual check writing system. Information from checks is input into an accounting software system used by the CPA firm, purchase journals are created, from which various reports can be generated. Vendor invoices are not verified against checks. See Trans, pp. 24 -47.

Mr. Smith testified that his participation in the audit was on the periphery and he was not interviewed by the auditor. He was requested to and did provide the daily sales records and monthly summary report; however, he testified that he was never requested to provide general ledgers, trial balances, purchase journals, or sales journals. Mr. Smith testified that the purchase journals were not requested or reviewed by the auditor. He also testified that the auditor did not suggest, nor did Petitioner implement any changes to the tax collection or reporting processes after the audit was complete. See Trans, pp. 20 - 61.

Petitioner's second witness was Joseph Tomczyk ("Mr. Tomczyk"), called as an expert witness based on his prior position as Director of Audit with Respondent and his many years as a practicing CPA. Mr. Tomczyk testified as to his knowledge of audit sampling methods. He also testified that reviewing purchase invoices as a way to determine accurate food exemption percentage may or may not be the most reliable method; i.e., reliability depends on the system of accruing taxes, internal controls, identifying if there is an incentive not to report accurately. He also testified that starting with purchases to arrive at a sales figure includes many assumptions and a number of forensic techniques. He stated that there are many more elements than just current month's purchases that go into or are related to sales. He testified that inventory turnover will impact the accuracy of the review and that purchased inventory does not necessarily result in a sale due to loss from spoilage, theft, breakage, etc. He stated that there can be an impact based on changes in purchase price or sale (i.e., mark-up) price. Trans, pp. 62-99.

RESPONDENT'S CONTENTIONS

Respondent contends that it performed a sales tax audit under the authority of MCL 205.3, and determined that Petitioner had incorrectly reported the amount of sales subject to taxation, by over reporting the allowance for food products exempt from taxation. Respondent's Motion and Brief to Establish Burden of Proof (Resp. Brief), p. 3. In this case, Respondent asserts that it had reason to believe that the records maintained or returns filed were inaccurate based upon the audit conducted. Resp. Brief, p. 6. As such, the assessment is considered prima facie correct pursuant to MCL 205.68(4) and Petitioner has the burden of proof of refuting that assessment. Respondent contends that its auditor properly determined the food for human consumption deduction and that its sampling method was valid. It states ". . . it is not enough to merely argue that the audit methodology used by the Department is not the most reliable, or that other methods might be used; it must be demonstrated that the method used was actually inaccurate." Resp. Brief, pp. 6-7, citing *By Lo Oil Co v Department of Treasury*, 267 Mich App 19, 42-43; 703 NW2d 822 (2005). Respondent further asserts that it "need only review that information it deems relevant," *Flynn v Department of Treasury*, unpublished opinion per curiam, Court of Appeals, Docket No. 231475 (2002), and that its auditor reviewed all of the records made available by Petitioner.

Respondent contends that a 10% negligence penalty is appropriate because the tax due was significant. The auditor stated in the audit report “[it] is reasonable to expect that an ordinarily prudent taxpayer would have noticed an error of this magnitude and taken steps to correct it.” Respondent’s Audit Report, p. 4.

Respondent called one witness, Justin Storey (“Mr. Storey”), senior auditor with the cash basis audit team in the compliance bureau. Mr. Storey testified that he was the auditor in this case and he described the procedures taken. He testified that he reviewed Petitioner’s daily sales records (albeit, not the Z ring tapes), sales tax returns, purchase invoices, federal tax returns, SBT returns, and profit and loss statements. He further testified that he was not provided the Z ring cash register tapes nor bank statements, cancelled checks, check register or check stubs. Mr. Storey testified as to the sampling method used, explaining that a two-month block sample of purchase invoices was used and a categorical mark up was applied to determine taxable and non-taxable sales. He generally described the various work schedules developed during the audit. Trans, pp. 99 – 113.

Mr. Storey testified that he did not consider Petitioner’s records to be adequate because, for one reason, he found that the comparison of the purchase invoices to the amount allocated as the monthly purchases was quite different. He stated that this suggested that all of the invoices were not provided to him. He also found that the daily sales sheets showed that the sales tax collected was not equal to the sales tax reported on the Z rings and he testified that he believed it was unlikely that rounding was the cause. Mr. Storey testified that in general Z rings cannot be relied upon because nobody observes the cashiers to ensure they ring up every transaction correctly or completely; therefore, from Respondent’s perspective, reviewing sales source documents is not an adequate way of determining taxable sales. Trans, pp. 113 – 116.

FINDINGS OF FACT

Petitioner is engaged in retail sales and primarily sells food for home consumption, exempt from sales tax. Petitioner also sells food for immediate consumption, not exempt from the sales tax. For the audit period at issue, Petitioner maintained complete and adequate sales records. Petitioner filed required tax returns and paid all sales tax collected. Petitioner had satisfactory internal controls, separating the duties of handling daily cash and financial reporting with the regular involvement of its outside CPA.

Respondent's audit determination was based on an audit block sample including a two-month test period: June and December of 2008. The audit determination was based on a review of purchase invoices, not sales transactions. Respondent's audit methodology resulted in an estimate based on purchases and several mark-up percentages, not an exact determination of tax based on actual taxable sales. Respondent's auditor determined an average food deduction of 41.5721% for each of the 48 months in the audit period whereas Petitioner used a food deduction based on the actual recorded sales transactions.

The auditor compared Petitioner's sales tax returns with amounts reported and no differences were found. The auditor determined that Petitioner's internal controls were not optimal because of the nature of its business. The auditor determined that the daily sales sheets were properly accruing sales tax. The auditor determined that block sampling method of audit would be the best method. The auditor found that the difference between the purchase spread and the allocated purchases per month was immaterial, and purchases were accepted as reported. The auditor found no material differences between the daily gross sales and the amounts reported on federal and state tax returns.

CONCLUSIONS OF LAW

The assessment at issue in this matter is for unpaid sales tax. The Sales Tax Act, 1933 PA 167 ("the Act"), 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:

- (i) [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.

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.

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:

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 what it believed to be the best information available, as is consistent with MCL 205.67 and *Vomvolakis v Department of Treasury*, 145 Mich App 238; 377 NW2d 309 (1984). The Court of Appeals in *Vomvolakis* affirmed the Tribunal's determination that a state revenue auditor did not exceed his authority in basing sales tax assessments against the petitioner on supplier summaries, under the belief that the petitioner did not keep accurate or complete records. MCL 205.67 establishes that the ". . . 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." The Tribunal in *Summerville v Department of Treasury*, MTT Docket No. 149724 (1994), stated that the "taxpayer must show that the assessments are improper, unlawful or inappropriate and what, if any, is the correct and proper tax liability."

Respondent's auditor attempted to defend the audit methodology, stating "once we determine that sales are not reliable, then we are forced to go from the purchase perspective." Trans. p. 115. Despite testifying that he requested but was not provided the cash register Z ring tapes, which are source documents, Respondent seems to completely discount the reliability thereof. He stated:

The problem with Z rings is that there is nobody observing the individual cashiers ringing up every transaction. Really no amount of training on these cashiers can guarantee that they are not going to ring stuff up into the wrong category accidentally or purposefully, so, therefore . . . the amounts reported on the Z ring are suspect right from the beginning. . . .[L]ooking at the sales from our

perspective is not an adequate way of determining the taxpayer's proportion of nontaxable sales and taxable sales." Trans. p. 115

There is nothing in the record to show that the Z rings were incorrect or otherwise not reliable other than Respondent's assertion that cash based transactions are always unreliable. In this case, it appears that, without observing or testing any transactions at the store and without looking at sales transaction source documents, Respondent's auditor determined that sales were not reliable. See Trans, pp. 120 & 122. The auditor testified that he did not review the Z rings or the sales reports. Trans, pp. 122 & 132. Based on testimony, the auditor's focus was on purchase invoices only, yet he relied on incomplete purchase information and failed to confirm the detail against Petitioner's purchase records (see Trans, pp. 113 & 129), resulting in an invalid sample and erroneous assumptions.

The Tribunal finds testimony by Petitioner's CPA, Mr. Smith, to be credible. He is very familiar with Petitioner's operations and the financial procedures followed. He testified that Petitioner's owner, Mr. Raykovitz, is "a hands-on manager at the store, in there pretty much seven days a week." Trans, p. 14. He further stated that Petitioner uses an updated cash register system which is programmed to include or not include tax depending upon the button pressed. Trans, pp. 16-18. Mr. Smith testified that Mr. Raykovitz and the other employees understand what constitutes exempt groceries and taxable prepared food, and is "very comfortable with their knowledge of the tax law and their operation of the cash register set up." Trans, p. 18. Mr. Smith described the daily cash processes stating "[a]t the end of the day both cash registers are reconciled by [Mr. Raykovitz] personally. He runs what's called a Z tape from each register which shows the total of sales for the day, . . . which totals the sales by category. And then on the bottom of his daily sheet he records whether the sale was by cash, check, or charge, and then he reconciles the cash register receipts, cash, check, and credit card deposits to the Z tape. . . ." Trans, p. 21. Mr. Smith further testified that his firm prepares the monthly and annual sales tax returns. Trans, pp. 21 & 22.

The Tribunal finds, based on Mr. Smith's testimony, that Petitioner's internal controls were adequate to ensure tax was properly collected and reported. He stated:

I'm confident that there are sufficient internal controls in place that the tax is being collected as it should be. . . . [Petitioner] does have in-store cameras for not only employee theft but for . . . customer theft and he can as well from the in-store camera see that his employees are complying as well. And with [Mr. Raykovitz]

being there as often as he is and us reconciling the bank accounts at the end of each month. producing a purchases journal, a sales journal, a general ledger, and a trial balance on a monthly basis, with our oversight, [Mr. Raykovitz's] oversight, the cameras, I think a business that grosses a half a million dollars, that's about as good as they can do on internal controls.

Trans, p. 24. Mr. Smith also testified that he does not believe anything was done wrong by Petitioner and that no changes have been made nor were suggested by Respondent, to better enhance the internal controls. Trans, pp. 25 & 26.

The Tribunal finds that Petitioner's records were suitable and adequate to determine the correct amount of tax. Mr. Smith testified that from the daily Z tapes and sales sheets provided by Mr. Raykovitz, Excel spreadsheets are prepared (see Exhibits P12, P13, P15, P16, P18, P19, P21, P22, P24, & P25) by his firm's personnel. Trans, pp. 27 – 29. He testified that the schedules are used to determine the monthly sales tax. Trans, p. 30. He also stated that the entries are reviewed for accuracy and that analytical procedures are performed to determine if something does not look accurate. Trans, pp. 31 & 34.

This Tribunal, upon due, careful, and deliberate consideration of the entire record in this matter, concludes that Petitioner's source documents were well maintained and adequate to allow the Tribunal to determine the proper sales tax due. As such, the burden of proof shifts to Respondent to show that the amount of tax paid was incorrect. The Tribunal further finds that the process and procedures followed by Respondent's auditor cannot be relied upon. The Tribunal agrees with Petitioner that Respondent's calculations and methodologies result in imperfect estimates because they are based on a sample of purchase invoices for two months, extrapolated over an almost four-year period, using an estimated "average" mark-up. Respondent does not consider inventory fluctuations, nor shrinkage inherent in a retail business. Although Respondent's audit methodology may be appropriate where a party has not maintained or otherwise provided sufficient sales source documentation, as determined in *Vomvolakis*, Petitioner has met its burden to refute Respondent's prima facie correct assessment and has further substantiated that no additional sales tax should be due for the reasons set forth herein.

JUDGMENT

IT IS ORDERED that Assessment No. R848672 is CANCELLED.

IT IS FURTHER ORDERED that the officer charged with collecting the affected taxes, interest, and penalties shall refund the taxes, interest, and penalties as required by this Order within 28 days of the entry of this Final Opinion and Judgment.

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

MICHIGAN TAX TRIBUNAL

Entered: September 26, 2011

By: Cynthia J. Knoll