

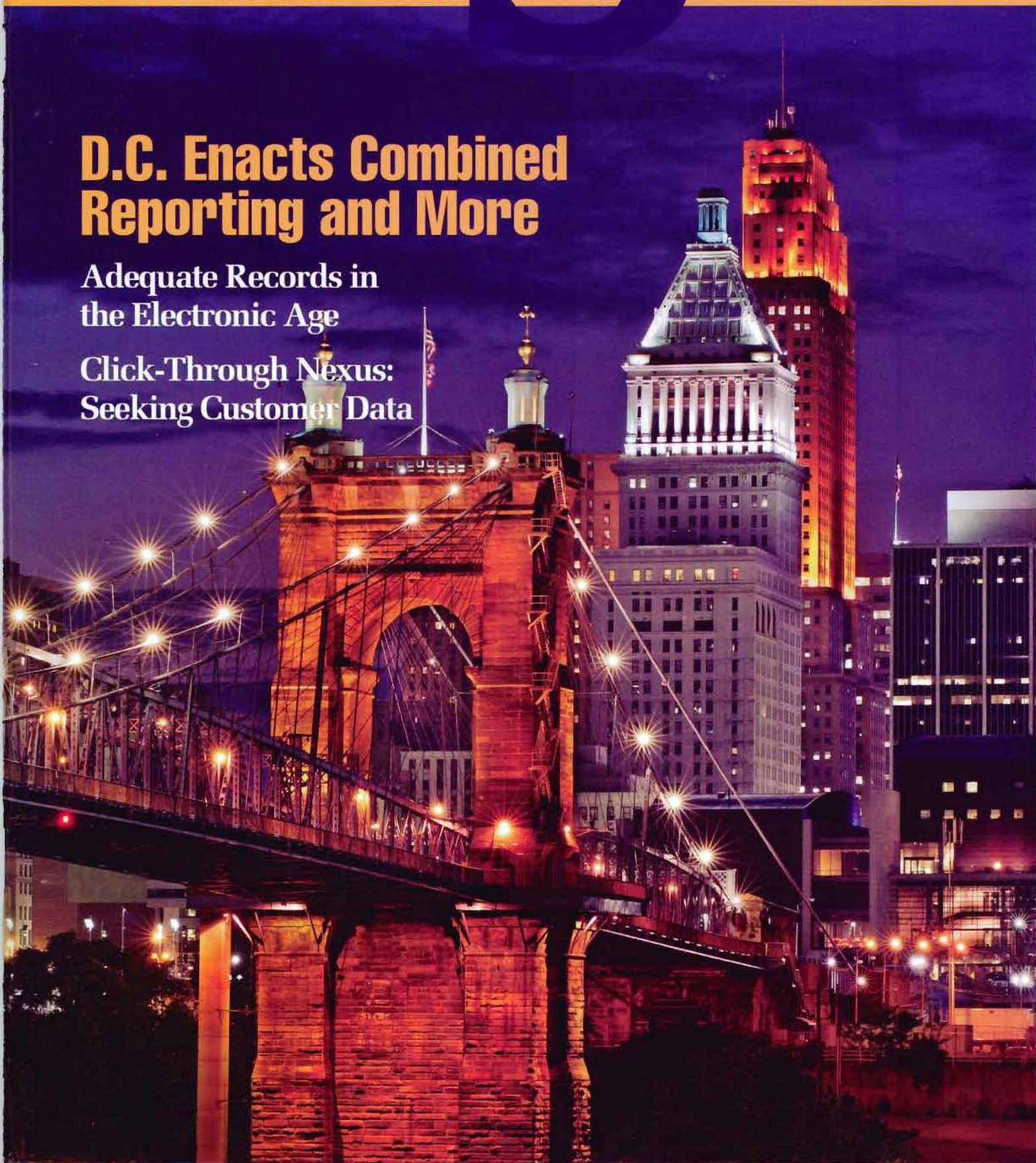
MultiState

TAXATION AND INCENTIVES

D.C. Enacts Combined Reporting and More

Adequate Records in the Electronic Age

Click-Through Nexus: Seeking Customer Data



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TAXATION AND INCENTIVES

SPECIAL REPORT

D.C. Enacts Surprises: Combined Reporting With Limited Use of NOLs, and Internet Vendor Sales Tax

CHRISTIAN M. MCBURNEY

The Fiscal Year 2012 Budget Support Act of 2011 (with its many tax provisions) became effective on 9/14/11, after the required 30-day congressional review period.

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Maintaining Adequate Books and Records for Sales and Use Tax in the Electronic Age

BARRY LEIBOWICZ

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**Maintaining Adequate Books and Records for Sales and Use Tax in the Electronic Age,
Journal of Multistate Taxation and Incentives**

PROCEDURE

**Maintaining Adequate Books and Records for Sales and
Use Tax in the Electronic Age**

Given that properly maintained books and records provide the best possible protection against excessive and unjust estimated tax assessments, vendors should keep records that are clearly sufficient for audit purposes.

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"The honest and conscientious taxpayer who maintains comprehensive records as required has a right to expect that they will be used in any audit to determine his ultimate tax liability." In this statement from the New York State Supreme Court Appellate Division opinion in *Chartair, Inc. v. State Tax Commission*,¹ which requires state auditors to conduct an examination using a vendor's own properly maintained records rather than indirect or estimated audit methodologies, lies the core issue in every sales and use tax audit in New York (and, likely, other jurisdictions). It is therefore crucial that businesses maintain books and records of sufficient quality and scope to satisfy the *Chartair* standard and to prevent assessments based on estimates. Businesses and

their tax advisors must therefore understand what is required for books and records to be considered adequate under the New York tax law.

Just this year, the New York State Department of Taxation and Finance (the "Department of Taxation") has issued multiple new guidance as to the standards for books and records in general and "point-of-sale" (POS) systems in particular.² The standards enunciated, however, seem to exceed past legislative or judicial requirements and may in fact be impossible to satisfy.

These changes include more-stringent standards for entities using automated POS systems as compared to their manual or register-only counterparts.³ Further, the increased requirements placed on users of POS systems may actually discourage their use in favor of traditional (and potentially less reliable) paper invoice and register systems. Finally, the Department of Taxation may have exceeded its authority in requiring POS systems to meet standards of reliability that exceed traditional systems that have a long history of acceptance in the courts. These Department of Taxation requirements, if enforced, would create a clearly inequitable situation, requiring even "mom and pop" stores in the state to use POS systems and to adhere to standards that would exceed not only any legitimate mandate under the statute but also the standards maintained by the Department for its own computerized recordkeeping systems.

Vendors Must Keep Adequate Books and Records

Every person required to collect New York State sales and use tax must maintain adequate books and records.⁴ On audit by the state, a vendor is required to produce all books and records specifically requested by the Department of Taxation.⁵ As noted above, when auditing a vendor the Department must use the vendor's books and records (if adequately maintained) to determine the correct sales and use tax liability.⁶

If a vendor does not produce adequate books and records on audit, the Department may resort to "external indices" or indirect audit methodologies to estimate the tax liability.⁷ Prior to applying an indirect audit methodology, however, the Department must thoroughly examine a vendor's records, because it is the inadequacy of those records that justifies the use of an indirect audit methodology.⁸ Thus, the Department may use indirect methodology in a sales tax audit only when, as stated in *Chartair*, the vendor's records are so insufficient that it is "virtually impossible to verify taxable sales receipts and conduct a complete audit."

As might be expected, when auditors are free to make estimates because adequate books and records are unavailable, they generally select the external indices that produce the highest assessment. Although the Department of Taxation is required to select a methodology reasonably calculated to reflect the tax liability based on "such information as may be available,"⁹ exactness in the outcome of the audit method is not required and considerable latitude is given to an auditor in selecting a method.¹⁰ The New York Tax Appeals Tribunal and the state's courts take the view that since the vendor had the opportunity to maintain books and records (and therefore to insulate itself from the vicissitudes of external indices) but chose not to, the vendor should bear the consequences. In essence, the courts declare that a vendor who fails to keep adequate books and records does so at his peril, since the need to resort to external indices is likely to produce a poor result, against which the vendor will have little or no defense.

Since the adequacy of records is critical to a fair audit result, it is imperative that the vendor understand the identity, type, and scope of records required in order to be deemed "adequate." At a minimum, the records must contain detail that is sufficient to allow the Department of Taxation to independently determine the taxable status of each sale and the tax due and collected thereon, and records must be kept by a system that creates a reliable indicator of the business's taxable sales and purchases.

The latest recordkeeping guidance.

If a vendor's business sales are subject to New York sales and use tax, the vendor is required to keep a record of every sale, the amount paid, and the tax due thereon. Specifically, N.Y. Tax Law §1135(a)(1) states: "Every person required to collect tax shall keep records of every sale or amusement charge or occupancy and of all amounts paid, charged or due thereon and of the tax payable thereon, in such form as the commissioner of taxation and finance may by regulation require." In its "Sales Tax Bulletin TB-ST-770" (*Recordkeeping Requirements for Sales Tax Vendors*, 6/2/11) (hereinafter, TB-ST-770 or "the Bulletin"), the Department of Taxation outlines the records that must be maintained by vendors subject to sales and use tax. The Bulletin thus identifies the basic sales and purchase records a vendor must maintain in order to be in compliance and thus avoid the possibility of an auditor's resorting to external indices or estimates.

Sales Records

As described in TB-ST-770, a vendor that is required to collect sales and use tax must maintain a true copy of the following records, as applicable:

- (1) Sales slips, invoices, receipts, contracts, statements, or other memorandum of sale.
- (2) Guest checks, hotel guest checks, receipts from admissions such as ticket stubs, receipt from dues.
- (3) Cash register tapes and any other original sales document.

If no written document is given to the vendor's customer, the vendor must keep a detailed daily record of all cash and credit sales in a daybook or similar journal. The vendor must also provide documentation that sufficiently details the taxable status of each sale and the tax due, so that an auditor can independently determine and confirm from such records that the proper amount of tax was collected.¹¹

In an earlier Technical Service Bureau Memorandum (TSB-M-81(9)S, 7/15/81, "Records Required to Be Kept by Sales Tax Vendors"), the Department of Taxation provided an example of what would constitute adequate records. The TSB indicates that cash register tapes that identify the individual items sold, the selling price, and the tax due (if any), "are sufficient to independently determine the taxable status of each sale and the amount of tax due and charged thereon," and thus would constitute adequate records. The TSB also indicates what would *not* constitute adequate records. For example, cash register tapes that indicate whether each sale is in a taxable or exempt category, but that do not identify the individual items sold, are sufficient only to prove gross sales but not to independently determine the taxable status of each sale.

TB-ST-770 explains that a vendor that sells both taxable and nontaxable goods or services must always identify which items are subject to sales tax, and the tax due must be separately stated on the invoice or receipt given to the customer. For example, as discussed above, a cash register tape must list each item sold with enough detail to determine whether that item is subject to sales tax.

If the vendor fails to separately state nontaxable and taxable items in a sale, the "cheese board" rule could operate to make the entire sale taxable. A New York sales tax regulation (20 N.Y. Codes, Rules & Regs. §527.1(b)) states: "When tangible personal property, composed of taxable and exempt items is sold as a single unit, the tax shall be collected on the total price." An

example in the regulation explains that when a vendor sells a package containing assorted cheese, a cheese board, and a knife (e.g., a "party platter"), the entire purchase is taxable. If the items are sold separately, however, and each item is identified and priced on the receipt, only the cheese board and knife would be taxable, and not the cheese. Similarly, if a vendor sells prewritten computer software, consulting services, maintenance, and training as separate line items, each with its own price, only the software itself would be taxable. Should the software and services be combined into a single, one-price package, however, the entire sale will be taxable as a computer version of the "cheese board" rule.

The sales tax rules are full of such "cheesy" traps. For example, woe unto a vendor that sells an item for \$100 plus an 8.5% sales tax but prepares a bill or invoice showing the sale at \$108.50 without separately stating the tax—or at the very least, stating specifically on the bill that the price includes an 8.5% sales tax. Since the vendor did not adequately state the amount of the sales tax on the bill, the entire \$108.50 will be treated as the purchase price subject to sales tax.

Furthermore, writing just "tax included" on the bill is not enough, since the Department of Taxation would not be able to determine the pre-tax price or whether the correct tax rate was applied. As such, the record would still be inadequate.

TB-ST-770 also states that a vendor that delivers a product to, or performs a service at, a place other than its place of business must maintain records that substantiate where delivery or performance took place.¹² This is particularly important, of course, if the out-of-state nature of the sale was the reason for not collecting sales tax. TSB-M-81(9)S indicates that appropriate records include receipts from parcel delivery services, common carriers, unregulated truckers, the U.S. Postal Service, foreign freight forwarders, and logs from company vehicles. These documents must be referenced to specific sales transactions; one should be able to trace the sale through the shipping bills of lading to a delivery outside New York, in order to support the out-of-state-delivery exemption.

Sales records regarding exempt customers.

Generally, all receipts from the sale of tangible personal property and enumerated services, all rents for occupancy, and all amusement charges are presumed taxable unless the contrary is established. The burden of proving exemption from tax is imposed on the person required to collect tax and the purchaser of the goods or services. A vendor is relieved of this burden,

however, and it remains solely upon the purchaser, if the sale is made pursuant to a properly completed exemption certificate received from the purchaser no later than 90 days after the date of sale or rendition of services, unless the purchaser's certificate of authority had been suspended or revoked or has expired.¹³

For example, as in generally all states that impose a sales tax, sales for resale in New York are not "retail sales" and thus are not subject to sales and use tax.¹⁴ In practice, it can be difficult for a vendor to determine whether a particular sale to a customer was for resale. A vendor is relieved of the burden to prove eligibility for the resale exemption if the vendor accepts in good faith a properly completed resale certificate from the customer; for the vendor's purposes, such sale is tax free as a matter of law.¹⁵ An exemption certificate is "accepted in good faith" when a vendor has no knowledge that the certificate or other document issued by the purchaser is false or is fraudulently presented. If reasonable ordinary due care is exercised, knowledge will not be imputed to the vendor required to collect the tax.¹⁶ Because this rule addresses the burden of proof, once a resale certificate is accepted in good faith it matters not to the vendor whether the certificate is accurate or whether the customer actually made the purchase for resale. Simply put, a vendor need not worry about collecting sales or use tax as long as the vendor acts in good faith in accepting a properly completed, timely resale certificate.

Similarly, good faith acceptance of a properly completed exemption certificate from a tax-exempt organization relieves the vendor of the obligation to collect tax, regardless of whether the charity is legitimate, whether the certificate is accurate, or whether the charity will in fact use the goods or services for its exempt purpose.

The operative term in each of these examples is that a "properly completed" exemption certificate must be received in order to secure the burden-shifting benefits of the statute.¹⁷ "Properly completed" means that the exemption certificates must be completed in its entirety, setting forth all of the required information, including whether it is a single purchase or a "blanket" certificate.¹⁸ A blanket resale certificate applies to a buyer's additional purchases of the same general type of property or service made within the prior 90 days or at any time thereafter.¹⁹

Exemption certificates must indicate the date the certificate was prepared, the names and addresses of the purchaser and vendor, the purchaser's taxpayer identification number, the signature of the purchaser or the purchaser's authorized representative, and any other

information required to be completed on the particular certificate or document.²⁰ The vendor must maintain a method of associating an exempt sale with the exemption certificate on file.²¹

Auditors, of course, carefully review these exemption certificates and may seize upon any omission or deficiency in an effort to "throw out" the exemption and tax the transaction. Therefore, good practice suggests that a business's own personnel or outside tax professionals periodically review each certificate no later than 90 days after the transaction to which it relates in order to catch and correct any deficiency before it becomes an excuse to deny the exemption on audit. With regard to blanket certificates, good practice dictates that they be reviewed periodically or even supplemented by new blanket certificates every few years.

Deductions and credits.

Given that sales are taxable at the time made, for subsequent events that give rise to deductions or claims for tax credits or refunds for bad debts, returned merchandise, and cancelled sales, vendors must adequately document such claims with complete records that show:

- (1) The date of original sale.
- (2) The name and address of the purchaser.
- (3) The amount the purchaser contracted to pay.
- (4) The amount on which the vendor paid tax.
- (5) All payments or other credits applied to the account of the purchaser and the date of such payments or credits.²²

Purchase Records

Purchases as well as sales are presumptively taxable, subject only to documented entitlement to a specific exemption provided in the tax law. Records must be maintained to establish the taxable status of all purchases of tangible personal property or services.²³ Absent documentation, exemptions such as those for resale or manufacturing will be denied and the tax imposed.

A vendor must therefore be concerned with maintaining adequate and complete documentation of any purchases, and the purpose of the purchase, if exemptions are to be protected. These purchase records must provide sufficient detail to independently determine the taxable status of

each purchase and the amount of tax due, paid, or remitted thereon. Purchase records must substantiate all expenses and cost of goods sold. These records should also show that a business's purchases bear a reasonable relationship to the business's sales. Vendors should also keep any other records or documents that, given the nature of the business, would be necessary to prove that they have collected and paid the proper amount of sales or use tax.²⁴

For New York State, purchase documentation should include records related to the following:

- (1) Purchases that are subject to all taxes.
- (2) Purchases for resale (inventory and raw materials).
- (3) Purchases that are subject to the New York City sales tax and statewide sales tax but exempt from other local sales taxes.
- (4) Purchases that are subject to the New York City sales tax but exempt from the statewide tax other local taxes.
- (5) Purchases that are exempt from statewide tax but subject to New York City and other local taxes.
- (6) Purchases that are exempt from all taxes for reasons other than for resale.²⁵

Not only must the details of the purchase itself be documented, but also the reasonable relationship of that purchase to the vendor's sales. It is relatively simple to maintain sufficient records for purchases of tangible personal property that is then resold, in an unaltered state, to customers. It is significantly more difficult, however, to keep records for purposes of the resale exemption when the goods purchased become part of something else to be sold, or when they provide the basis to claim the manufacturing exemption for the items used to produce the goods for sale.

Take, for example, a vendor in the business of heating, ventilation, and air conditioning (HVAC) that installs and services air conditioning systems and also sells ducts and other manufactured parts to other HVAC companies and building supply retailers. The vendor buys sheet metal by the truckload and fabricates the metal into ductwork. The ductwork is then either installed as part of capital improvements or repairs for customers or resold to other companies for their use or resale. For the ductwork incorporated into capital improvements, the vendor must pay sales or use tax on the sheet metal used in manufacturing the ducts. Also, the vendor must collect sales

tax on the ductwork sold to other contractors. By contrast, for the sheet metal used to manufacture the ductwork used in repair jobs upon which the vendor must collect sales tax, as well as the ductwork sold to retailers for resale, the production or resale exemption is available.

Similarly, the manufacturing exemption can apply to the HVAC firm's purchases of machinery used to manufacture the ductwork, provided the portion manufactured for resale is sufficient to trigger the exemption. Businesses engaged in the manufacture or production of tangible personal property for resale can purchase machinery and equipment (and the energy to run them) tax free. To qualify, the machinery and equipment must be used directly and predominantly (more than 50% of the time) in the production of tangible personal property for sale.²⁶

The manufacturing exemption is not proportionate to the quantity of tangible personal property produced for sale. Rather, it is "all or nothing." For example, if the machinery is used more than 50% of the time to produce property for sale, the purchase of the machinery will be exempt from tax. If the machinery is used less than 50% of the time to produce property for sale, the purchase of the machinery is fully taxable. In contrast, utilities (e.g., electricity) used to drive the machinery are excluded from tax in direct proportion to the nontaxable use.²⁷ Thus, if a machine is used 75% of the time to manufacture goods for resale, it is 100% exempt on purchase but only 75% of the energy it uses is exempt. If used only 25% of the time to manufacture goods for resale, it is 100% taxable on acquisition but 25% of the energy it consumes is exempt.

While the rules may seem simple, they are a nightmare in application, particularly in meeting the Department of Taxation's requirement that "[f]or purposes of the exemption, adequate records must be maintained to support exempt use."²⁸ The HVAC vendor in the above example would be required to document, to a legal certainty, the precise quantity of sheet metal used for each piece of duct, which in turn must be tracked to each particular use and type. The vendor would have to establish some recordkeeping system to document the exact percentage of time that the machinery had been used to produce each piece of that duct and to document the purpose of each piece so produced in order to qualify for any exemption for the machinery or energy. The consequence of failing to satisfy the Department's very stringent recordkeeping requirements with this type of accuracy is the loss of exemptions to which the enterprise may in fact be entitled. Further, the smaller the vendor's business, the less likely it can afford the extensive in-depth cost-accounting and tracking systems necessary to satisfy the Department's demand for

documentation of the vendor's entitlement to exemptions, or the nature of a sale and its resultant tax status. There is, however, one glimmer of hope on the energy-consumption side. The Department has stated that it will accept an "engineering survey" in determining proper allocations of energy used for taxable and nontaxable uses, and it has adopted formulas for certain industries.²⁹

Thus, from the manufacturer of HVAC ductwork to a baker who "manufactures" donuts for sale to customers, "adequate books and records" requires very detailed cost-accounting and production-process analysis if the vendor is to preserve the exemptions to which it is entitled.

Form of Records Required

Vendors are expected to maintain any records that, given the nature of their business, are necessary to prove that they have collected and paid the proper amount of sales or use tax due.

The Department of Taxation requires that a vendor maintain separate accounting records for each business for which the vendor has a certificate of authority. All records, including sales memoranda, purchase memoranda, and records originated at the time of sale, and any other documents, books, or records pertaining to tax liability and tax collections must be dated, legible, and maintained and preserved in such manner as to disclose in readily accessible and verifiable detail the basis for and accuracy of the entries reported on the sales and use tax return. These records may be reproduced by any process (e.g., photograph, photostatic, microfilm, etc.) that actually reproduces the original record.³⁰

For vendors that maintain records in an electronic format, all requirements for paper records also apply to records created and stored electronically. Records that are maintained in an electronic format must be made available to the Department of Taxation in an electronically readable form.³¹

Point-of-Sale (POS) Systems

In TB-ST-770, the Department of Taxation provides further guidance on the proper maintenance of books and records when using an electronic POS system to record transactions subject to New York sales and use tax. POS systems are used to record sales to a business's customers and, in many ways, take the place of a traditional cash register. When using POS, all sales are transacted via a computer system that records what the vendor is selling, the selling price, and

the quantity sold. Then the program calculates the total due (including any applicable sales tax), and, for cash sales, even tells the vendor how much change is due. The system should record every sale and track all transactions.

The Department's current requirements for POS system sales records.

Under the most recent guidelines (TB-ST-770) issued by the Department of Taxation, a vendor that uses a POS system must use one that the Department deems adequate; each POS transaction record must provide enough detail to independently determine the taxability of each sale and the amount of tax due and collected. The Department requires detailed information for each sales transaction, including but not limited to the following:

- (1) Individual items sold.
- (2) Selling price.
- (3) Tax due.
- (4) Invoice number.
- (5) Date of sale.
- (6) Method of payment.
- (7) POS terminal number and POS transaction number.³²

Any summary documents should be designed so that the details underlying the documents, such as invoices and vouchers, may be identified and made available upon request. Any additional reports or schedules used in connection with the preparation of the tax return must be kept and made available upon request.³³

In addition to POS sales records, the taxpayer is also required to maintain purchase records. Detailed information required for each purchase transaction includes but is not limited to the following:

- (1) Individual items purchased.
- (2) Date of purchase.
- (3) Purchase price.

- (4) Vendor name.
- (5) Invoice number.
- (6) Total invoice amount.
- (7) Purchase order number.
- (8) Method of payment.³⁴

Any related inventory systems, as well as any additional purchase reports, schedules, or documentation that reconcile to other books and records, such as purchase journals or a general ledger, must be maintained and made available upon request. Electronic records must permit the direct reconciliation of the receipts, invoices, and other source documents with the entries in the books and records and on the tax returns. Otherwise, the records may be deemed inadequate to permit a detailed audit and another audit methodology (such as a sampling) may be used.³⁵

POS System Internal Controls

The users of POS systems must maintain auditable internal controls to ensure the accuracy and completeness of the transactions recorded in the POS system. The records must provide the opportunity to trace any transaction back to the original source or forward to a final total. Audit trail details include, but are not limited to:

- (1) Internal sequential transaction numbers.
- (2) Records of all POS terminal activity.
- (3) Procedures to account for voids, cancellations, or other discrepancies in sequential numbering.³⁶

The POS audit trail or logging functionality must be activated and operational at all times, and it must record any and all activity related to other operating modes available in the system, such as a training mode; and any and all changes in the setup of the system. Failure to have the POS audit trail or logging functionality activated and performing these functions is evidence of a lack of POS system internal controls. In fact, a taxpayer's books and records may be deemed inadequate if the audit trail were ever deactivated and if the date, time, and description of every record change were not recorded.³⁷ This is required of every taxpayer using a POS system.

Remarkably, TB-ST-770 seems to have gone far beyond any statutory, regulatory, or judicial requirements previously imposed upon the use of an electronic recordkeeping system. Further, in addition to the stringent requirements it specifically enumerates, the Bulletin states that the specifications "do[] not provide an exhaustive list of the records [a vendor] must keep." The Bulletin thus makes it impossible to specify what features are sufficient in a POS program to ensure acceptance as adequate by the Department of Taxation. In fact, the Bulletin thus penalizes businesses that adopt electronic POS systems by imposing requirements that are at once so stringent and yet so open-ended that the U.S. Defense Department's electronic systems might fall short, let alone those systems commercially available for purchase by a "mom and pop" business. When coupled with the Department's recently proposed legislation, the Bulletin's demands may make it effectively impossible to adopt and maintain a POS system that is affordable, manageable, and adequate under Department's requirements. Apparently, the last thing the Department strives for is predictability or certainty that a business will be able to meet its standards and avoid the use of external indices on audit.

The Department's concern about potential misuse of electronic systems and the stringent TB-ST-770 is not only counter-productive, it is also paradoxical given the Department's disregard for internal controls in its own electronic recordkeeping. For example, the Department uses its own proprietary "front-end" software in tax audits. The Vista module of its "Audit Framework Extension" (AFE) is used for sales tax audits. The program is essentially an adaptation of a Microsoft FoxPro database, which provides a means of collecting and filling-in data on predefined Microsoft Excel spreadsheets and Microsoft Word documents. The Department will not release the AFE software, and a vendor's audit data files are unreadable without it. As such, the Department's records are effectively shielded from review under the Freedom of Information Law (FOIL).³⁸ This stands in marked contrast to the Department of Taxation's demand that all software used for POS systems be readable by commonly available commercial software.

What is even more disconcerting is that, despite the Department's demand that every vendor in New York maintain recordkeeping procedures and systems that have internal control systems that are essentially infallible, the Department chooses to maintain an audit recordkeeping system for itself that lacks internal controls entirely. For example, in litigation in the Division of Tax Appeals, the Department has stipulated the following:

"The Audit Framework Extension (AFE) application developed by the New York State Department of Taxation and Finance does not maintain a history of changes to files or data records within its case folder or database for each audit case. No audit trail or other logging system has been implemented to track ongoing changes for an audit case."³⁹

Therefore, although the integrity of all records maintained by Department of Taxation in every sales tax audit in this state depends on an electronic recordkeeping system of their own creation that has absolutely no internal controls at all, the Department insists that every vendor, including the smallest, least sophisticated merchants, maintain POS systems with extraordinary and possibly unattainable levels of internal controls.

As indicated above, TB-ST-770 requires that vendor POS systems maintain an audit trail feature that creates a record of every transaction performed using the system. This record includes the date, time, and detailed description of any changes made to the sales invoice from the original transaction source to the final total. In fact, a vendor's books and records would be considered inadequate if the audit trail function were deactivated at any time, and the date, time and description of every record change was not recorded. This requirement is placed on every vendor that uses a POS system, including "mom and pop" operations without any technical sophistication and lacking any information technology budget or personnel.

It is clear that the Department of Taxation's new rules hold vendors to a standard significantly more stringent than ever before required for paper or electronic systems, and exponentially higher than that used by the Department to maintain its own records. In a conference call related to litigation with the Department of Taxation under FOIL, the programmers who wrote the AFE software admitted that the audit program does not track when changes are made to AFE files, who made the changes, and when and how often the records were accessed. The program does not keep track of whether the documents and records have been accessed at all. Any Department personnel with access to the AFE program can alter documents without leaving a trace, and thus, apparently someone could rewrite the critical history of the audit. At the very least, given all of its technical resources and personnel, the Department should maintain an AFE system with at least the same integrity as that which the Department requires of the sandwich shop down the block from its offices. It cannot be reasonable for the Department to demand an

extraordinary, unusual, and possibly commercially unattainable level of internal controls in POS systems in order to find them to be adequate, while at the same time asserting that its own electronic recordkeeping system, which has no internal controls at all, is adequate for sales tax audit purposes.

Nor does the fact that these records are kept by an agency of the state provide the requisite level of comfort in the presence of a system with no internal integrity. For example, the system used by the Department of Taxation for "in-dating" records received is simply a rubber hand-stamp with a manually adjustable date. Accurate receipt dates are extremely important in our tax system. They are critical for determining timeliness of filing, penalties, interest, and the running of statutes of limitation, to name just a few issues. A lack of internal controls in making sure the correct date is applied should be disturbing.

Even more disturbing, however, is when official policy condones, or even encourages, the backdating of documents. For example, in 2008, a Department of Taxation employee, while backdating documents, made an error that may have resulted in the exposure of the seemingly fraudulent practice of backdating documents at the Department. Rather than punish what seemed to be misconduct, however, the management of that Department office simply established a procedure for backdating documents so as to prevent similar mistakes in the future. In an e-mail dated 2/19/08, a high-level official in that district office advised all personnel that "[f]or the future, we have a separate, extra, stamp to be used for backdating items."⁴⁰ When the author learned of these procedures, he brought them to the Department's attention. The Department, however, apparently has done nothing to improve the integrity of the date-stamping process or hold any participants accountable for backdating of records that likely would be prosecuted as a criminal offense if done by a vendor or the vendor's representative.

The Department of Taxation now demands POS systems that go far beyond anything generally available in commerce, and beyond the level of internal controls inherent in traditional paper systems. Further, these additional demands are made without any corresponding additional authority and without any change in the level of internal controls required for traditional paper and register-based systems. TB-ST-770 may create an entirely new and extraordinary internal control requirement, while lacking statutory authority or consistency with other types of accounting. Further, these rules are promulgated in the context of the Department's lack of internal controls in

its own recordkeeping systems. This certainly leaves open the argument that if normal POS systems with current levels of internal controls are inadequate, then the Department's own records, produced on systems without any internal controls at all, and with documented misuse and abuse, are insufficient to carry their burden in supporting an assessment. At the very least, the courts may not support a demand for POS controls that discriminates against vendors choosing to use, instead of paper records, reasonable commercially available POS systems (which are equally reliable as paper records previously accepted by the courts).

Failure to Maintain or Provide Adequate Records

When a taxpayer is selected for audit, the auditor will review the books and records to verify taxable sales for the audit period, analyze sales invoices or other source documents on which tax has been charged, verify that the that proper amount of tax has been collected, trace selected source documents through the accounting systems to journals and ledgers, and record sales tax collection errors on work papers. In examining the records, the auditor may claim they are inadequate for any of the following reasons:

- (1) They do not verify sales receipts, or whether the sales receipts are subject to the sales tax.
- (2) They do not provide sufficient details of each individual transaction.
- (3) They do not verify the taxable status of the business's purchases.
- (4) They do not show how purchases correlate to sales.
- (5) The taxpayer failed to provide all records to the auditor.
- (6) They records are not in auditable form.
- (7) The POS system's audit trail features do not provide adequate internal control procedures that assure the accuracy and completeness of the transactions recorded.⁴¹

Failure to maintain proper records provides the Department of Taxation with multiple options for assessing sales tax charges. The auditor can use alternative methods to determine an estimated sales tax liability, possibly resulting in a greater tax assessment. The alternative methodologies used by auditors may include:

- (1) A test period for sales.

(2) Onsite observations of business activities (observations can last for as little as one day).

(3) Bank deposit methodology (the taxpayer must prove which deposits are not sales).

(4) External ratio or index method. (Apply standard published ratios and indices to the taxpayer's data. The ratios, however, may not be reflective of the taxpayer's activities.)

Further, to invalidate an estimated assessment, the vendor must show "by clear and convincing evidence" that the method used was "unreasonably inaccurate or that the tax assessed [was] erroneous."⁴² Numerous cases decided by the Division of Tax Appeals and the Tax Appeals Tribunal rule in favor of the Department, finding that any imprecision in the audit determination arose as a result of the taxpayer's failure to maintain adequate books and records.

In addition to an increased tax assessment, the Department can impose severe penalties on a taxpayer that fails to keep adequate books and records. Any vendor that fails to make, maintain, or provide to the Department on request, the required books and records, is subject to a penalty of \$1,000 for the first quarter the failure occurs, up to a maximum of \$5,000 for each additional quarter the failure continues.⁴³ Furthermore, any vendor who fails to present the books and records in an auditable form is subject to a \$1,000 penalty for each quarter the failure occurs; this penalty applies even though the records are adequate to verify credits, receipts, and the taxability of the sales represented.⁴⁴ An additional \$5,000-per-quarter penalty applies for taxpayers who choose to maintain business records in electronic format and fail to make the records available to the Department in electronic format, even though the records also are available in hard copy format.⁴⁵

Adequate Request for and Sufficient Investigation of Vendor's Records

In order to determine the adequacy of a vendor's records, the Division of Taxation must first request⁴⁶ and then thoroughly examine⁴⁷ the vendor's books and records for the entire period of the proposed assessment.⁴⁸ The purpose of the examination is to determine, through verification drawn independently from within the vendor's records,⁴⁹ whether the records are so insufficient that it is "virtually impossible [for the Division] to verify taxable sales receipts and conduct a complete audit ... from which the exact amount of tax can be determined."⁵⁰

Unfortunately, while the Department of Taxation officially states that it wants businesses to maintain sufficient records, it simultaneously encourages its auditors to bypass vendor records and use estimated audit methodologies by pressuring them to meet "production goals," thereby providing auditors with an incentive to find business records to be inadequate. Given that the Department maintains and disseminates production statistics for auditors that show the "dollars per day" of taxes assessed by any particular auditor, it is made clear to auditors that it is in their best interest to find records inadequate and then use an estimate to assess tax. A quick and limited review of records as the means to produce a substantial estimated assessment is likely to result in a very high production number, while spending some time to do a thorough audit of detailed records will do exactly the opposite. Therefore, in practice the Department pressures the auditors to produce fast and large assessments through estimates and external indices. It is thus crucial for vendors to maintain exemplary records so that Department's auditors can find no excuse to set the records aside for an estimated assessment.

In *Matter of Trusnovec d/b/a Yaphank Community Shop*,⁵¹ the Tax Appeals Tribunal stated: "There is little guidance for determining what constitutes an adequate request for books and records by the Division other than that the request for records must be explicit and not weak and casual. There is no formal or informal requirement to send such a request by registered or certified mail."⁵²

In *Matter of RYKG, Inc.*,⁵³ the administrative law judge (ALJ) found that the "[t]he original appointment letter sent by the Division to RYKG constituted an adequate request for books and records." The Department of Taxation has further expanded what constitutes an adequate request. The following requests are *not* considered insufficient: (1) oral request for records for an updated, extended audit period; (2) written request for records for that same period; and (3) additional "numerous oral requests for petitioner's records for the entire audit period."⁵⁴

In the *Matter of Trusnovec*, the taxpayer argued that he had not received the request for books and records. The ALJ had found that the auditor had sent the request four times: three by ordinary mail and once by certified mail. Although the address used by the Division on its mailing label was, as noted by the ALJ, "incomplete," it was the address used on the taxpayer's business checks and bank statements, and was successfully used to mail the notices of determination to the petitioner. The certified mailing was marked "return to sender" because, according to the

Postal Service, it was "unclaimed," but the three first-class mailings were not returned to the Division. The Tribunal rejected the taxpayer's argument that there was a conspiracy which resulted in his not receiving these letters when they were sent. Noting that the "silence of the Tax Law and regulations with regard to the form of requests for books and records accords the Division broad discretion in the mode it chooses to use in any particular circumstance," the Tribunal held that "the use of first class and certified, return receipt requested mail was more than a weak and casual request for books and records." In addition, "[t]he fact that the first class mailings were not returned and the certified mailing was returned as 'unclaimed' indicates that *petitioner was aware of the requests.*" Finally, "[t]he four mailed requests satisfied the ... requirement for more than a weak and casual request for books and records. It was petitioner's burden to show that these requests were insufficient." (Emphasis added.)

Sufficient investigation of vendor's records.

Once an adequate request for a vendor's books and records is made, the Department of Taxation must thoroughly examine those documents in order to justify a conclusion that the books and records would be incapable of supporting a complete audit.⁵⁵ As noted above, it is the inadequacy of the books and records that justifies the use of an indirect audit methodology.⁵⁶ The vendor must provide the auditor with original source documents in order to constitute adequate books and records.⁵⁷ Moreover, if a tax assessment was estimated, the Department must so indicate on the notice of determination.⁵⁸ Nevertheless, if a vendor is not misled or prejudiced by the notice's failure to indicate that the tax was estimated, the notice remains valid.⁵⁹

Using indirect audit methods.

If a proper determination is made that the books and records are incomplete or inaccurate, the Department of Taxation may then resort to external indices to estimate the tax liability.⁶⁰ Examples of such external indices are provided in N.Y. Tax Law §1138(a)(1), which provides, in pertinent part: "If a return required by this article is not filed, or if a return when filed is incorrect or insufficient, the amount of tax due shall be determined by the commissioner from such information as may be available. If necessary, the tax may be estimated on the basis of external indices, such as stock on hand, purchases, rental paid, number of rooms, location, scale of rents or charges, comparable rents or charges, type of accommodations and service, number of employees or other factors."

The Department can use any indirect audit method, as long as the method is reasonable. Furthermore, the use of the method must be reasonably calculated to reflect the taxes due and, finally, the results must not be erroneous. The vendor bears the burden of proving with clear and convincing evidence that the assessment is erroneous,⁶¹ or that the audit methodology is unreasonable.⁶² Exactness in the outcome of the audit method is not required.⁶³

The New York State Department of Taxation and Finance's "Indirect Audit Methods Trainer's Manual" sets forth a hierarchy of indirect audit methods. According to the manual, as a case goes through the appeals process, the strongest approach is a markup test to arrive at audit findings, using either some of the vendor's records or third-party information. The next strongest method is an observation test, followed by the use of a prior audit. According to the manual: "The last, and least accurate would be the use of external indices. These are industry averages throughout the country or region." The manual further states: "Somewhere in between the use of a prior audit and the use of external indices would be the District Office index. This is better than the external indices in that the results of the data collected is localized." Finally, the manual states, in bold print: "Major point to stress: The more you use the vendor's records, the stronger the case will be."

Conclusion: Adequate Books and Records Protect Against Estimated Assessments

Given that properly maintained books and records provide vendors with the best possible protection against excessive and unjust estimated assessments, it is important that vendors keep records that are clearly sufficient for audit purposes. Examples of records that contain adequate internal controls against abuse or fraud and that have been found adequate include sequentially numbered guest checks and register tapes that provide sufficient detail to ensure that taxable and nontaxable items can be identified and verified. Register tapes also should have appropriate totalizers so as to record all sales and produce an appropriate "Z" tape total.

POS systems should have internal controls and protections against abuse that make them at least as reliable as the equivalent traditional paper systems. This author believes, however, that it would be improper for the Department of Taxation to insist on commercially unattainable levels of internal controls in POS software, since doing so would demand levels of assurance higher than from authorized paper systems that both the Department and the courts historically deem

acceptable. A POS system that provides a level of internal control, reliability, and integrity at least equal to that of generally accepted paper accounting systems, should constitute "adequate books and records" as the term is used in *Chartair*. To the extent that the Department disregards such a system and estimates a tax liability because the POS system does not meet the unreasonably high standards arbitrarily imposed by TB-ST-770 without statutory authority, the Department violates the mandate of *Chartair*, and the resulting assessment should be set aside.

¹

65 App Div 2d 44 , 411 NYS2d 41 (3d Dept., 1978).

²

Sales Tax Bulletin TB-ST-770: Recordkeeping Requirements for Sales Tax Vendors (N.Y.S. Dept. of Tax'n, 6/2/11); *Publication 900: Important Information for Business Owners* (N.Y.S. Dept. of Tax'n, May 2011).

³

See Solieri, "New York's New Recordkeeping Guidance for Sales Tax Vendors," [21 JMT 6 \(September 2011\)](#) .

⁴

N.Y. Tax Law §1135. Under §1131(1), for purposes of the sales and use tax recordkeeping requirement, a person includes "every vendor of tangible personal property or services; every recipient of amusement charges; and every operator of a hotel," as well as "any officer, director or employee of a corporation or of a dissolved corporation, any employee of a partnership, any employee or manager of a limited liability company, or any employee of an individual proprietorship who as such officer, director, employee or manager is under a duty to act for such corporation, partnership, limited liability company or individual proprietorship in complying with any requirement of this [sales and use tax] article."

⁵

N.Y. Tax Law §1135(g).

⁶

Chartair, Inc. v. State Tax Comm'n, *supra* note 1. Also see *Matter of Marine Midland Bank, N.A.*, N.Y. Div. of Tax App., ALJ Determination, No. 807533, 17/16/92, *aff'd* N.Y.S. Tax App. Trib., DTA

No. 807533, 5/13/93.

7

N.Y. Tax Law §1138(a)(1); *Chartair, Inc. v. State Tax Comm'n*, *supra* note 1.

8

King Crab Restaurant, Inc. v. Chu, 134 App Div 2d 51 , 522 NYS2d 978 , 1987 WL 29119 (3d Dept., 1987).

9

N.Y. Tax Law §1138(a)(1).

10

See *Matter of Gifts by Gallego, Inc.*, N.Y. Div. of Tax App., ALJ Determination, No. 810018, 2/18/93, *aff'd* N.Y. Tax App. Trib., DTA No. 810018, 12/23/93. See also *Meyer v. State Tax Comm'n*, 61 App Div 2d 223 , 402 NYS2d 74 (3d Dept., 1978), *app. den.* 44 N.Y.2d 645, 406 N.Y.S.2d 1025, 377 NE2d 749 (1978); *Markowitz v. State Tax Comm'n*, 54 App Div 2d 1023 , 388 NYS2d 176 (3d Dept., 1976), *aff'd* 44 N.Y.2d 684, 405 N.Y.S.2d 454, 376 NE2d 927 (1978) (as a general proposition, any imprecision in the results of an audit arising by reason of a vendor's own failure to maintain adequate and accurate records of all of its sales, as required by N.Y. Tax Law §1135(a)(1), must be borne by that vendor).

11

See *Matter of Crescent Beach, Inc.*, N.Y. Div. of Tax App., ALJ Determination, Nos. 822080, 822081, 822082, 822083, 7/15/10 (vendor's books and records were found to be inadequate where vendor provided guest checks but failed to produce a general ledger, register tapes, or other proof of an internal control over the guest checks, making an accurate audit impossible).

12

A special rule applies to motor vehicles, trailers, and certain boats. For more information, see *Publication 750: A Guide to Sales Tax in New York State* (N.Y.S. Dept. of Tax'n, June 2010). TB-ST-770, *supra* note 2.

13

N.Y. Tax Law §1132(c); 20 N.Y. Codes, Rules & Regs. §§532.4(a) and (b). Also see TSB-M-81(9)S, 7/15/81 ("Records Required to Be Kept by Sales Tax Vendors").

14

N.Y. Tax Law §1105; 20 N.Y. Codes, Rules & Regs. §526.6(c).

15

N.Y. Tax Law §1132(c); 20 N.Y. Codes, Rules & Regs. §526.6(c).

16

20 N.Y. Codes, Rules & Regs. §532.4(b)(2)(i).

17

Of course, in the absence of a properly completed exemption or resale certificate, a vendor is still free to otherwise prove the right to the resale or charitable exemption but that generally is with great difficulty and cost, and often insufficient to secure the desired relief.

18

N.Y. Tax Law §1132(c); 20 N.Y. Codes, Rules & Regs. §532.4(b)(2)(ii); *Sales Tax Bulletin TB-ST-240: Exemption Certificates for Sales Tax* (N.Y.S. Dept. of Tax'n, 3/26/10).

19

20 N.Y. Codes, Rules & Regs. §532.4(d)(4). Also see Publication 750, *supra* note 12; TB-ST-240, *supra* note 18; Form ST-120 (Resale Certificate); Form ST-121 (Exempt Use Certificate).

20

See note 18, *supra*.

21

20 N.Y. Codes, Rules & Regs. §532.4(d)(4).

22

TSB-M-81(9)S, *supra* note 13.

23

TB-ST-770, *supra* note 2.

24

Id.

25

TSB-M-81(9)S, *supra* note 13.

26

Sales Tax Information for: Manufacturers, Processors, Generators, Assemblers, Refiners, Miners and Extractors, Other Producers of Goods and Merchandise (Publication 852, N.Y.S. Dept. of Tax'n and Finance, December 1997).

27

Id.

28

Sales Tax Bulletin TB-ST-690: Production Equipment and Utilities Used by Supermarkets, Grocery Stores, and Delis (N.Y.S. Dept. of Tax'n, 4/13/11).

29

Id., citing Publication 852, *supra* note 26, for the formula to be used in determining the amount of electricity used in production.

30

TSB-M-81(9)S, *supra* note 13.

31

TB-ST-770, *supra* note 2.

32

Id.

33

Id.

34

Id.

35

Id.

36

Id.

37

Id.

38

The author is currently engaged in litigation in the Appellate Division of the New York State Supreme Court in an effort to secure the release of the AFE software under FOIL.

39

A copy of the stipulation may be found (via the author's website, "Tax Defense Information Center") at www.taxdefenseinformationcenter.org/Stip%20of%20Facts%20for%20AFE.pdf.

40

A copy of the "backdating" e-mail may be found (also via the author's website) at www.taxdefenseinformationcenter.org/Backdating%20%20NYS%20foiled%20email.pdf.

41

TB-ST-770, *supra* note 2.

42

Locke and Salzman, "1992 Survey of New York Law—State Taxation," 44 Syracuse L. Rev. 499 (1993), page 529 (citing *Meskouris Bros., Inc. v. Chu*, 139 App Div 2d 813 , 526 NYS2d 679 , 1988 WL 30491 (3d Dept., 1988)).

43

N.Y. Tax Law §1145(i).

44

N.Y. Tax Law §1145(j).

45

N.Y. Tax Law §1145(k).

46

Christ Cella, Inc. v. State Tax Comm'n, 102 App Div 2d 352 , 477 NYS2d 858 (3d Dept., 1984).

47

King Crab Restaurant, Inc. v. Chu, *supra* note 8.

48

Adamides v. Chu, 134 App Div 2d 776 , 521 NYS2d 826 , 1987 WL 4471 (3d, Dept., 1987), *app. den.* 71 N.Y.2d 806, 530 N.Y.S.2d 109, 525 NE2d 754 (1988).

49

Giordano v. State Tax Comm'n, 145 App Div 2d 726 , 535 NYS2d 255 , 1988 WL 126633 (3d Dept., 1988); *Hennekens v. State Tax Comm'n*, 114 App Div 2d 599 , 494 NYS2d 208 (3d Dept., 1985); *Urban Liquors, Inc. v. State Tax Comm'n*, 90 App Div 2d 576 , 456 NYS2d 138 (3d Dept., 1982); *Meyer v. State Tax Comm'n*, *supra* note 10.

50

Chartair, Inc. v. State Tax Comm'n, *supra* note 1. Also see *Christ Cella, Inc. v. State Tax Comm'n*, *supra* note 46; *Mohawk Airlines, Inc. v. Tully*, 75 App Div 2d 249 , 429 NYS2d 759 (3d Dept., 1980).

51

N.Y. Tax App. Trib., DTA No. 811135, 4/10/97.

52

For the "not weak and casual" standard, the Tribunal cited *Christ Cella, Inc. v. State Tax Comm'n*, *supra* note 46, where the court annulled the Department's determination, finding the

auditor's argument "that the register tapes were never provided is diminished by the weak and casual request made for them...." In rejecting the auditor's alternative method "markup test," the court stated that "the department [must] request the tapes before commencing the markup test, for it is the lack of adequate records that authorizes the use of the test."

53

N.Y. Div. of Tax App., ALJ Determination, No. 819983, 1/12/06.

54

Matter of What a Difference Cleaning, Inc., N.Y. Div. of Tax App., ALJ Determination, No. 820745, 5/3/07.

55

King Crab Restaurant, Inc. v. Chu, *supra* note 8.

56

Chartair, Inc. v. State Tax Comm'n, *supra* note 1.

57

Matter of The Humphrey House, Inc., N.Y. Tax App. Trib., DTA Nos. 813375 and 813376, 7/31/97, *aff'g and modifying* N.Y. Div. of Tax App., ALJ Determination, Nos. 813375 and 813376, 8/1/96.

58

N.Y. Tax Law §1138(a)(2).

59

See Matter of Bowen d/b/a Ron's Discount Liquor, N.Y. Tax App. Trib., DTA No. 808168, 1/20/94.

60

Urban Liquors, Inc. v. State Tax Comm'n, *supra* 49.

61

Scarpulla v. State Tax Comm'n, 120 App Div 2d 842 , 502 NYS2d 113 (3d Dept., 1986).

62

Surface Line Operators Fraternal Organization, Inc. v. Tully, 85 App Div 2d 858 , 446 NYS2d 451 (3d Dept., 1981). Also see Matter of Cousins Service Station, Inc., N.Y. Tax App. Trib., DTA Nos. 801070 through 801073, 801084, 801085, 8/11/1988.

63

Markowitz v. State Tax Comm'n, *supra* note 10. Also see Matter of Cinelli d/b/a Shoporama Car Wash, N.Y. Tax App. Trib., DTA No. 802576, 9/14/89.

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