Cite as Det. No. 99-341, 20 WTD 343 (2001)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of Assessment of	)	D E T E R M I N A T I O N
	)	
	)	No. 99-341
	)	
. . .	)	Registration No. . . .
	)	FY. . ./Audit No. . . .
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. . .	)	Registration No. . . .
	)	FY. . ./Audit No. . . .

[1] MISCELLANEOUS: SALES TAX -- AUDITS – TEST PERIODS – REASONABLE RESULTS. The use of test periods is an appropriate audit procedure if proper consideration is given to factors which could lead to other than reasonable results. Test period found acceptable where taxpayer purchases were used to project taxable sales and where an adjustment was made for the fact that taxable items sold more slowly than exempt items at a grocery store.

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Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

NATURE OF ACTION:

Specialty grocery store objects to audit test period . . .[1]

FACTS:

Dressel, A.L.J. -- . . . (taxpayers)[2] owned and operated a grocery store that featured [specialty] items. Their books and records were examined by the Department of Revenue (Department) for the period January 1, 1993 through December 31, 1994. As a result a tax assessment, identified by the above-captioned numbers, was issued for $. . . . The taxpayers appeal.

. . . (taxpayer) is the corporate successor of [taxpayers]. The corporation and the two individuals will hereafter be referred to as "the taxpayers". In addition to continuing operation of the . . .'s original store in [Washington City], the corporation started stores in [Washington City] in 1995

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.
[2] Nonprecential portions of this determination have been deleted.

and in [Washington City] in 1996. The books and records of the corporation were examined by the Department for the period January 1, 1994 through December 31, 1996.[3] As a result a tax assessment, identified by the above-captioned numbers, was issued for $. . . . The taxpayers appeal part of that assessment.

In addition to sales tax-exempt groceries, the taxpayers sold various, taxable non-food products such as kitchenware, gift items, beauty and hygiene products, herbal supplements and adjuncts, carbonated beverages, bottled water, small dishes, . . ., and other [specialty] items of kitchen equipment . . . . In making sales the taxpayers did not utilize scanning equipment to distinguish nontaxable items from taxable ones. Instead, they relied on their checkers to be aware of what was taxable and what was not and to push the appropriate buttons on their cash registers. Although the taxpayers claim to have cash register receipts (Z tapes) that reflect all sales, otherwise, their records were lacking. The Audit Division of the Department (Audit) reports that, at the time of the audit, the taxpayers had no summary records, such as a general ledger or similar financial record.

In its examination of the taxpayers' records, Audit used 1996 *purchases* in a test period to determine what percentage of total sales was exempt of sales tax and what percentage was subject to sales tax. Audit determined that 10.273% of total purchases was of items subject to sales tax when sold at retail. Audit then applied this percentage to the taxpayers' sales for the entire audit period to determine taxable and nontaxable sales. As justification for this approach, Audit cites the taxpayers' incomplete records, the fact that those records do not identify which items were coded taxable or nontaxable, and the fact that the taxpayer did not use scanning equipment. At page two of its Auditor's Detail of Differences and Instructions to Taxpayers, Audit writes:[4]

> Per WAC 458-20-244(6), persons operating businesses with a combination of sales are required to segregate between taxable and tax exempt sales. "It is sufficient segregation for accounting purposes if cash registers or electronic checking machines are programmed to identify and separately tax food products which are not tax exempt." Since your cash registers are not programmable to scan and identify products, your business relies on your cashiers to identify a taxable sale and to code the sale as taxable. The cash register has only one category for taxable sales. Therefore, there is not a way of identifying which items are coded as "taxable grocery" verses "non taxable grocery".
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> Based upon the above circumstances, this method of testing exempt food sales was determined appropriate.

The taxpayers do not believe that this method results in an accurate breakdown of taxable and nontaxable sales. They state that any test period should reflect their sales rather than their

[3] Both the sole proprietorship and corporate entities operated simultaneously for a time in 1994, until the former was merged into the latter.

[4] The Auditor's Detail of Differences and Instructions to Taxpayers is the narrative portion of the audit report that is issued to taxpayers.

purchases, because the retail sales tax is based on sales. They do not believe that their purchase percentages and their sale percentages are the same. They cite a couple of reasons for this. First of all, the turnover of their nonfood products is slower than the turnover of food products. Some of the nonfood items, such as [specialty items], are high-ticket items, much higher in price than average grocery items. Also, the nonfood products are not perishable and so can be displayed longer. In addition, when newer models of some of the nonfood items are introduced, the older models move even slower. Finally, because of competition for a limited customer base, the taxpayers must inventory their unique nonfood products just to bring customers in the door.

The other main reason the taxpayers cite for their position that Audit's breakdown is inaccurate is the opening of their new [Washington City] store in the test year, 1996. Because that was a brand new store, the taxpayers made inordinate expenditures for nonfood products in order to establish an adequate inventory of same at the new location. Figuring this atypical purchasing pattern into the test period had the effect of skewing the taxable versus nontaxable allocation.

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ISSUES:

1. Did the Department err in establishing a test period for taxable sales at a grocery store in that taxable items sold at a slower pace than nontaxable food items?

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DISCUSSION:

[1] Test periods are a tool commonly utilized by the Audit Division. They save time by allowing the close examination of a shorter period to be projected over a longer period of time. That way fewer transactions have to be individually scrutinized. Test periods must be used with caution, however, to insure that the resulting projections are accurate. In that regard we stated:

> Many years ago the Department of Revenue's predecessor, the Tax Commission, expressed its philosophy on the use of test periods in these words:
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> > [3] Much can be said about the merits of the use of test periods in audit examinations; however, we believe this practice represents acceptable audit methods and procedures when conditions warrant its use. We believe also that reasonable results may be had from a testing of certain periods providing the tests will disclose the normal and usual errors of omission and commission and will relate such errors to the full audit period under examination and to this end the Tax Commission subscribes to the following guiding principles.

> First of all, an analysis of the business activities must be made to insure that if seasonal influences are available proper consideration must be given to this factor when selecting periods for testing. When errors are discovered they must be studied as to their nature and if representing an unusual and infrequent transaction, they should not be considered when making projections for the full audit period. In addition, the selection of test periods should be made with full understanding and agreement between representatives of the taxpayer and the Commission in order to insure the reasonable results desirable.
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> That philosophy still obtains.

Det. No. 88-233, 6 WTD 59, 62-63 (1988). At the time of the audit, the taxpayers' representative agreed to the use of 1996 as a test period. He believed then, though, that any projection would be based on the taxpayers' *sales* for the period. He did not realize that Audit would project sales based on the taxpayers' *purchases* during the test period. As alluded to earlier, the taxpayers do not believe their purchases and sales during 1996 tracked one another. The primary reason for that was that more nonfood inventory had to be purchased during that time to adequately stock the new [Washington City] store. An additional reason is that, according to the taxpayers, the taxable nonfood items sell at a slower pace than do the nontaxable food items.

Responding to the taxpayers' contention that the test period was not representative, Audit reduced "the disallowed exempt food deduction by . . . %".[5] In other words, the percentage of sales subject to sales tax was adjusted to a point in between the Department's purchase-based figure of 10.273% and the taxpayers' 6.795% figure which was calculated from the Z tapes.[6] The taxpayers, however, were still not satisfied. In support of their position, their accountant made his own analysis of taxpayer purchases. Like the Department, he listed purchased items as taxable or not taxable when sold. According to him, his analysis corroborated the Z tape result of 6.795%.

On Schedule IV of the corporation's assessment, Audit listed items from the taxpayer accountant's analysis that, it says, he coded incorrectly. Included there are such things as gas ranges, butane gas, BBQ lighters, dish sponges, chopsticks, compact disks, audio tapes, carbonated beverages, bottled water, and kitchenware. According to Audit, these items were posted, in the taxpayers' analysis, as nontaxable. They are, however, obviously, taxable when sold at retail.[7]

Given this extensive list of erroneously-coded items, we are not persuaded that Audit's figure of 10.273% is very far off the mark. It is axiomatic that items purchased for inventory are intended for sale. This, coupled with Audit's . . . % concession, mentioned above, leads us to conclude

[5] Reflected in Schedule I of the sole proprietorship audit and in Schedule IV of the corporation's audit.
[6] Z tapes are cash register tapes that give a cumulative total of taxable and non-taxable sales.
[7] As to the sales taxability of carbonated beverages and bottled water, see WAC 458-20-244.

that the test period *was* representative. While we agree with the taxpayers' accountant that a breakdown of *sales* is preferable when allocating *sales* tax, no reliable records were available vis-a-vis sales. A taxpayer who fails to keep suitable records may not successfully complain about an ensuing tax assessment. RCW 82.32.070; WAC 458-20-254. The Audit Division did the best it could with what records were available, namely, listings of items purchased for inventory by the taxpayer.

We conclude that the test period was reasonably representative. On this first issue, the taxpayer's petition is denied.

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DECISION AND DISPOSITION:

The taxpayers' petition is denied in part and granted in part.

DATED this 29th day of December, 1999.