JURISDICTION: **OKLAHOMA TAX COMMISSION DECISION**
CITE: **2008-09-16-03 / NON-PRECEDENTIAL**
ID: **P-07-035-K**
DATE: **SEPTEMBER 16, 2008**
DISPOSITION: **SUSTAINED**
TAX TYPE: **SALES / WITHHOLDING / USE / FRANCHISE**
APPEAL: **NO APPEAL TAKEN**

ORDER

The above matter comes on for entry of a final order of disposition by the Oklahoma Tax Commission. Having reviewed the files and records herein, including the Findings of Fact, Conclusions of Law and Recommendations made and entered by the Administrative Law Judge on the 3rd day of July, 2008, the Commission makes the following Findings of Fact and Conclusions of Law and enters the following order.

STATEMENT OF THE CASE

A field audit of Protestants' available records for the periods inclusive of the months of April, 2004 through June, 2007, was performed by the Compliance Division of the Oklahoma Tax Commission. As a result of the audit, the Division, on November 22, 2006, issued proposed sales, withholding, use and franchise tax assessments against the Corporation and proposed sales, withholding and use tax assessments against PRESIDENT as President of the Corporation and as an individual. Protestants timely protested the proposed assessments by letter dated January 22, 2007.

On March 8, 2007, the protest was referred to the Office of the Administrative Law Judges ("ALJ's Office") for further proceedings consistent with the Uniform Tax Procedure Code[1] and the Rules of Practice and Procedure before the Oklahoma Tax Commission[2]. The protest was docketed as Case No. P-07-035-K and assigned to ALJ, Administrative Law Judge.[3]

A pre-hearing conference was scheduled for April 25, 2007, by *Prehearing Conference Notice* issued March 29, 2007.[4] The conference was held as scheduled. Pursuant to the conference, the parties were directed to file a status report on or before June 25, 2007. On May 7, 2007, a *Motion to Strike Status Report and to Schedule a Hearing* was filed by the Division, which was granted by *Order* issued May 9, 2007. The hearing was scheduled for May 30, 2007, by *Notice of Hearing* issued May 9, 2007.[5]

On May 16, 2007, counsel for Protestants filed an *Entry of Appearance* and *Motion for Extension of Deadlines*. By *Notice of Hearing* issued May 18, 2007, the hearing was rescheduled for June 28, 2007. By *Order Granting Motion for Additional Extension of*

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[1] 68 O.S. 2001, § 201 et seq.
[2] Rules 710:1-5-20 through 710:1-5-47 of the *Oklahoma Administrative Code* ("*OAC*").
[3] *OAC*, 710:1-5-22(b).
[4] *OAC*, 710:1-5-28(a).
[5] *OAC*, 710:1-5-29.

Deadlines the hearing of June 28, 2007 was stricken and rescheduled for August 15, 2007. On August 15, 2007, Protestants reported to the hearing with four (4) boxes of sales invoices that the Division had not previously reviewed. By *Order* of the Administrative Law Judge, the hearing was cancelled and Protestants were directed to provide copies of the invoices to the Division. On October 15, 2007, the Division reported its findings and with the agreement of Protestants, requested that this matter be set for hearing.

In compliance with the directive of the Administrative Law Judge, Protestants on August 31, 2007, filed a *Withdrawal of Protests* to the withholding and use tax assessments issued by the Division. Protestants had also previously filed franchise tax returns for the audit period, which returns were accepted as filed, and the Corporation was reinstated.

The hearing was scheduled for November 20, 2007, by *Notice of Hearing* issued October 15, 2007.[6] A closed hearing was held as scheduled.[7] AUDITOR, field auditor, testified with respect to his review of the Protestants' sales invoices and the conduct of the audit. WITNESS testified in regard to the nature of Protestants' business and the deposits to Protestants' operating account. Protestants' Exhibits 1 through 3 were admitted into evidence without objection. The Division's Exhibits A and B, F and G and M through X were also admitted into evidence without objection. Upon conclusion of the hearing, the record was held open for the Division to submit Protestants' sales tax reports for the periods inclusive of the months of July, 2004 through November, 2004, and for the parties to file post-trial findings, conclusions and recommendations.[8] On March 5, 2008, the record was closed and the case was submitted for decision.[9]

FINDINGS OF FACT

Upon review of the file and records, including the transcript of the hearing, the pleadings of the parties and the exhibits received into evidence, the undersigned finds:

1. The Corporation began business in the spring of 2004. The President and only listed officer of the Corporation is PRESIDENT. The *Business Registration Application* of the Corporation reports that the Corporation's principal type of business is wholesale and its principal products are collegiate accessories and tobacco products. The Corporation has a sales tax permit and wholesale cigarette license issued by the Tax Commission. The Corporation is mainly a cigarette wholesaler. Division's Exhibit A; Tr. 6.

2. Protestants' warehouse was located at ADDRESS in CITY in a wholesale/industrial area. Tr. 18-19. The location did not have a retail outlet from which merchandise could be sold. Tr. 15. Beside cigarettes at the location, Protestants had several, but not a significant amount of NASCAR, OU, OSU and Big XII paraphernalia. Tr. 15; 17. Except for the deposits into Protestants' operating account which according to the auditor Protestants could not account for,

[6] *OAC*, 710:1-5-29.
[7] Protestants invoked confidentiality pursuant to 68 O.S. 2001, § 205.
[8] *OAC*, 710:1-5-32(3).
[9] *OAC*, 710:1-5-39(a).

the auditor was unable to say whether he had a belief that Protestants sold anything to the general public. Tr. 16-17. According to Protestants' witness, Protestants intended to sell the novelty items to their retail customers who had sales tax permits; however, the items were slow movers and a huge ticket loss to Protestants. Tr. 59; 25 and 26. Protestants did sell some of the items; however, a majority was either donated to charity or retained by them. Tr. 35; 59 and 26. The auditor testified that a few sales invoices had items other than cigarettes listed on them. Tr. 76.

3. The routine sales tax audit was performed in connection with the audit of Protestants' wholesale cigarette tax reports and non-participating manufacturer reports, and resulting *Complaint for Revocation/Cancellation of Wholesaler Cigarette License and Sales Tax Permit and Imposition of Fines and Civil Penalties*.[10] Tr. 4; 61. Division's Exhibits O and P.

4. All of Protestants' monthly cigarette tax reports for the period inclusive of the months of May, 2004 through May, 2005 were according to the auditor filed late and in batches. Tr. 8-9. An audit of the reports only "revealed no additional tax due." Tr. 9-10; 17. Protestants' Exhibits 1 and 2. The reports reflect the number of cigarettes purchased by Protestants during the period.

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[10] Case No. JM-06-023-K to which official notice is taken. The Findings of Fact as taken from the *Findings, Conclusions and Recommendations* issued in that case are as follows, to-wit:

1. Respondent is a domestic for profit business corporation, and since May, 2004, is a licensed cigarette wholesaler. Respondent also holds a sales tax permit issued by the Oklahoma Tax Commission.

2. Respondent's failure to file monthly cigarette tax reports and non-participating manufacturer reports has been the subject of two (2) previous show cause proceedings. In May, 2006, Respondent was cited for failure to file twenty-three (23) delinquent reports. Respondent subsequently filed those reports, but during the interim its cigarette stamp tax purchase discount was suspended. In August, 2006, Respondent was cited for failure to file the required monthly reports due subsequent to the May, 2006 show cause proceeding. Respondent filed those reports prior to the date of the show cause proceeding which effectuated the cancellation of that proceeding.

3. The current show cause proceeding was necessitated by Respondent's failure to timely file the required monthly reports due subsequent to the August, 2006 notice. The cigarette tax reports for the months of September, 2006 through December, 2006 were filed January 9, 2007. Based on information available to Complainant from shipping companies of cigarette shipments to Respondent, Respondent failed to report some cigarettes and these reports are consequently incorrect or incomplete. Further, not only the information available to Complainant, but the filed reports show that Respondent purchased cigarettes from other than the manufacturer or first importer of the cigarettes. Also, a single report for each of the non-participating manufacturers Respondent did business with during 2006 was improperly filed on January 9, 2007, rather than monthly non-participating manufacturer reports.

4. The Complainant has attempted to conduct an audit of Respondent's business since May, 2006. Records to conduct the audit have been requested on four (4) separate occasions. The only requested record Respondent has provided is parts of a general ledger which at least part of only show deposit summaries. Respondent has not provided sales invoices, a customer list or a sales tax permit list. Also, Respondent has not provided any back-up documentation in support of the deposit summaries.

5. Although, Complainant observed items, such as novelties (NASCAR memorabilia, Big XII school emblems and logos) in Respondent's warehouse during its inspection of Respondent's premises on June 2, 2006, which would be subject to sales tax rather than cigarette or tobacco products taxes, Respondent has never filed a sales tax report. In May, 2004, when Respondent was issued its license and sales tax permit, cigarettes were subject to sales taxes and Respondent was required to have a sales tax permit to conduct business. Respondent admits that it has sold approximately $750.00 of OU and OSU memorabilia items (key rings) during its existence.

6. Respondent purchased cigarettes from Tobacco Row of Kansas, a licensed Oklahoma cigarette wholesaler and was instructed to report the sale of those cigarettes because Respondent purchased the tax stamps notwithstanding that the tax stamps were applied to the cigarettes before Respondent purchased them.

7. Respondent believes that except for the sales invoices it is attempting to reconstruct, it has provided sufficient documentation to conduct the audit.

(Footnote omitted).

Tr. 8-9; 12. The reports also show Protestants purchased 3,300,000 Oklahoma cigarette stamps during the period of May through December, 2004, and only 60,000 compacted stamps during the period of January through May, 2005. Tr. 11, 19. Protestants' Exhibit 1 and 2. According to Protestants' witness, the increase and decrease in the purchases of stamps was due to the legislative change in the way cigarettes were taxed and that they sold a significant amount of cigarettes leading up to January 1, 2005. Tr. 20.

5. The sales tax audit commenced in August, 2006, with a second records request. Tr. 61. Division's Exhibit P. The second records request was made necessary because the only records received pursuant to the first request of May 17, 2006, were a chart of accounts, a general ledger for 2005 and 2006, some bank statements and some use tax invoices. Tr. 62-63; 64. Division's Exhibit O. No invoices of Protestants' sales to third parties were provided to the auditor in performing the initial audit. Tr. 4; 64. According to Protestants' witness, Protestants did not keep sales invoices, but rather made a spreadsheet every Monday and deleted them every Monday. Tr. 37.

6. In performing the audit, the auditor essentially subjected every bank deposit to Protestants' operating account to sales tax because Protestants did not provide sales invoices or show proof of their sales. Tr. 13; 64. Since the auditor was only provided the 2005 and a portion of the 2006 general ledgers, Protestants' total deposits to its operating account in 2005 were divided by 12, to arrive at an average and the average was applied to each of the months in the 2004 portion of the audit period (June through December). Tr. 64-65. Protestants' total deposits to its operating account in the first five (5) months of 2006 were divided by five (5) to arrive at an average and this average was applied to the months of June and July, 2006. Tr. 65.

7. As proposed by the audit, Protestants' sales for the period inclusive of the months of June, 2004 through July, 2006, were $12,340,670.76. Tr.65-66. Division's Exhibit B.

8. As a result of the audit, the Division by letters dated November 22, 2006, proposed assessments against Protestants of state and city sales taxes in the aggregate amount of $1,033,531.20, interest at fifteen percent (15%) through January 5, 2007 of $217,084.71, for a total of tax and interest due within thirty (30) days of $1,250,615.91, and a thirty (30) day delinquent penalty at ten percent (10%) of $103,353.15, for a total of tax, interest and penalty due after thirty (30) days of $1,353,969.06. Tr. 66. Division's Exhibits F and G.

9. Protestants timely protested the proposed assessments by letter dated January 22, 2007. Tr. 67. Division's Exhibit M.

10. After the assessment was issued, Protestants filed sales tax and cigarette reports with the Tax Commission. Tr. 18; 67. Protestants also submitted bank statements, and at the August 15, 2007 hearing, sales invoices to the Division. Tr. 67. Attached to the bank statements were deposit slips for every deposit to Protestants' operating account, which included a lot of cash deposits and copies of checks from Protestants' customers. Tr. 15; 28.

11. Protestants' sales invoices provided at the August 15, 2007 hearing were contained in four (4) boxes. Tr. 5. Supposedly, all of Protestants' sales invoices for the audit period except

the 2004 time period were included in the boxes. Tr. 21; 33; 72. The Division's Exhibit W reflects three (3) invoices for the month of June, 2005, which were attached to the monthly cigarette tax report filed by Protestants for June, 2005, and which were not included in the invoices submitted on August 15, 2007. Tr. 72. Also, the Division's Exhibit S reports sales of cigarettes to Indian tribes; however, no sales invoices for tribal sales were included in the sales invoices provided by Protestants. Tr. 74. According to Protestants' witness, all of their sales invoices were lost in a power surge that corrupted their computer; however, a computer expert was able to retrieve all but the 2004 sales invoices from a corrupted memory stick. Tr. 21; 37-39. Every invoice from January 3, 2005 through the month of November, 2005 is dated. Tr. 25. The invoices for December, 2005 through the remainder of the audit period are dated August 14, 2007 because, due to time constraints, Protestants did a global print of the invoices on August 14, 2007. Tr. 22; 25.

12. In reviewing the sales invoices, the auditor disregarded all of the invoices dated August 14, 2007 because the invoices weren't numbered and they were outside the audit period. Tr. 5. The auditor also noted that approximately two-thirds (2/3) of the invoices reported zero dollars thus no sale. Tr. 6. According to Protestants' witness, they had over 200 customers and each customer did not make a purchase each week so if a customer did not make a purchase in the week a zero (0) invoice was generated; however, if they did make a purchase the invoice shows the amount of the purchase. Tr. 23; 25.

13. The auditor totaled the sales invoices without zeros for the three (3) month period inclusive of April through June, 2005. Tr. 7; 69. Division's Exhibits R, T and V. According to the auditor, he could not reconcile the totals from the sales invoices with either the sales tax reports which were filed by Protestants on April 20, 2007, the monthly cigarette tax reports or the deposits to Protestants' operating account for the three (3) month period. Tr. 7; 69-72. Division's Exhibits N; R, T and V; U, S and Q. The auditor testified that no adjustment was made to the audit based on the sales tax reports filed by Protestants because the reports show all sales were exempt without back-up documentation. Tr. 68. Division's Exhibit N.

14. According to the auditor, he was told Protestants did not have the sales tax permits of their customers. Tr. 14. According to Protestants' witness, he doesn't recall any request for copies of the customers' sales tax permits. Tr. 39. See, Division's Exhibits O and P. Protestants' witness also stated that by looking at the invoices, the Division had a complete list of their customers. Tr. 25.

15. Protestants' witness, a professional gambler testified that he deposited personal funds, and cash and casino checks from gambling into Protestants' operating account to cover expenses. Tr. 27-28. He also testified that his son helped finance Protestants' and his gambling habit by transmitting over $1,000,000.00 in wired funds and that employees of Protestants often requested cash for their payroll checks which he would deposit into the account. Tr. 27-28; 42. Protestants' witness also identified Protestants' Exhibit 3, which lists checks and cash deposits other than normal checks from customers into Protestants' operating account. Tr. 27. Protestants' Exhibit 3. The auditor testified that in reviewing the bank deposits he saw a lot of certified checks which were made out to WITNESS that were re-deposited into Protestants' operating account. Tr. 77. Protestants' witness testified that no gift taxes were paid or loan

papers made with respect to the monies transmitted by his son. Tr. 42-44. Further, he stated that he does not have any 1099G's for the gambling proceeds, nor did he report the gambling proceeds on his federal income tax returns. Tr. 45-46.

ISSUE AND CONTENTIONS

The issue presented for decision is whether the sales tax audit and assessment are supported by substantial evidence.

Protestants contend that they have sustained their burden of proving the sales tax audit and assessment are incorrect by the law, the testimony of the witnesses and the exhibits. In support of this contention, Protestants argue that (1) it is admitted they were a cigarette wholesaler; (2) that they did not have a retail outlet and did not sell to the general public; (3) that they sold to retailers as evidenced by their sales invoices; (4) that after December 31, 2004, cigarettes were not subject to sales tax; (5) that prior to December 31, 2004, they purchased $3,300,000.00 worth of cigarette stamps; and (6) that the vast majority of deposits to the operating account were from non-taxable sources as evidenced by the deposit slips.

The Division contends that Protestants have failed to sustain their burden of proving by a preponderance of evidence that the audit is incorrect. In support of this contention, the Division argues that Protestants failed to meet statutory requirements to keep proper records supporting sales of tangible personal property and records of sales for resale; therefore, the bank deposits should be considered a record of their sales.

CONCLUSIONS OF LAW

WHEREFORE, premises considered, the undersigned concludes as a matter of law that:

1. The Tax Commission is vested with jurisdiction of the parties and the subject matter of this proceeding. 68 O.S. Supp. 2002, § 221(D).

2. The collection and remittance of sales tax is governed by the Oklahoma Sales Tax Code ("Code").[11] An excise tax is levied upon the gross receipts or gross proceeds of all sales, not otherwise exempted by the Code. 68 O.S. 2001, § 1354(A). Incorporated cities, towns, and counties are authorized to levy taxes as the Legislature may levy for purposes of state government, including a consumer sales tax. 68 O.S. 2001, §§ 2701 et seq. and 1370 et seq., as amended.

3. Prior to January 1, 2005, the retail sale of cigarettes was subject to sales tax as the sale of "tangible personal property." 68 O.S. 2001, § 1354(A)(1). Subsequent to January 1, 2005, sales of cigarettes on which the tax levied in 68 O.S. § 301 et seq. has been paid are exempt from sales tax. *OAC*, 710:65-13-30(H)(3).

[11] 68 O.S. 2001, § 1350 et seq.

4. Every wholesaler[12] of cigarettes doing business in Oklahoma is required to affix or cause the same to have affixed thereto the stamp or stamps required by § 301 et seq. upon withdrawal from storage, and before making any sale or distribution of cigarettes for consumption thereof, and to supply and charge to the retailer the necessary stamps to cover any and all drop shipments of cigarettes billed to the retailer by the wholesaler. 68 O.S. Supp. 2003, § 305(A).

5. The records and reports required of a wholesaler of cigarettes are set forth in § 312 of the Cigarette Stamp Tax Act, which provides in pertinent part:

> (a) Every person subject to the payment of a tax hereunder shall keep in Oklahoma accurate records covering the business carried on and shall for three (3) years, and more if required by the rules and regulations of the Tax Commission, keep and preserve all invoices, showing all purchases and sales of cigarettes; and such invoices and stock of cigarettes shall at all times be subject to the examination and inspection of any member or legally authorized agent or representative of the Commission, in the enforcement of this article. * * *
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> (b) Every wholesaler * * * shall file a report with the Commission on or before the 10th day of each month covering the previous calendar month, on forms prescribed and furnished by the Commission, disclosing the beginning and closing inventory of unstamped cigarettes, the beginning and closing inventory of stamped cigarettes, the beginning and closing inventory of cigarette stamps, the number and denomination of cigarette stamps affixed to packages of cigarettes, and all purchases of cigarettes by showing the invoice number, name and address of the consignee or seller, the date, and the number of cigarettes purchased, and such other information as may be required by the Tax Commission.[13]

6. The Division argues that Protestants failed to meet their statutory obligations for keeping and maintaining records and records of sales for resale citing the records and reporting requirements of the Code; specifically, 68 O.S. 2001, § 1365(F) and *OAC*, 710:65-3-30 and 31. Subsequent to January 1, 2005, Protestants were not "vendors"[14] within the meaning of the Code, except with respect to their Big XII and NASCAR paraphernalia which the auditor admitted was not significant.

7. In administrative proceedings, the burden of proof standard is "preponderance of evidence." 2 Am.Jur.2d *Administrative Law* § 357. See, Oklahoma Tax Commission Order No. 91-10-17-061. "Preponderance of evidence" means "[e]vidence which is of greater weight or more convincing than the evidence which is offered in opposition to it; that is, evidence which as a whole shows that the fact sought to be proved is more probable than not." Black's Law

[12] Defined at 68 O.S. Supp. 2003, § 301(c)

[13] See, 68 O.S. Supp. 2005, § 312.1 which sets forth procedures for maintaining records and filing reports. See also *OAC*, 710:70-2-1 et seq. which does not set forth any additional record or report requirements of wholesalers.

[14] See, 68 O.S. 2001, § 1352(28).

Dictionary 1064 (5th ed. 1979). It is also defined to mean "evidence which is more credible and convincing to the mind * * * [T]hat which best accords with reason and probability." *Id.*

8. An order of the Tax Commission must be supported by substantial evidence. ***Dugger v. State ex rel. Oklahoma Tax Commission***, 1992 OK 105, 834 P.2d 964. Likewise, the audit upon which a portion of the record is formed and order issued, must be supported by substantial evidence. Oklahoma Tax Commission Order No. 2003-07-22-09, 2003 WL 2347117.

An audit is supported by substantial evidence when an evidentiary foundation for the audit has been established. In a majority of cases, the evidentiary foundation will be established by the records reviewed by the auditor. In those cases where an evidentiary foundation for the audit has been established, the taxpayer has the burden of proving in what respect the action of the Tax Commission in assessing the tax is incorrect. *OAC*, 710:1-5-47; ***Enterprise Management Consultants, Inc. v. State ex rel. Oklahoma Tax Commission***, 1988 OK 91, 768 P.2d 359. However, where an evidentiary foundation has not been laid or the records upon which the audit is based do not establish a basis for assessing a tax, the audit and assessment in the initial instance cannot be sustained as being supported by substantial evidence. ***Dugger***, supra.

9. Notwithstanding Protestants' deficient record keeping, an evidentiary foundation has not been laid for subjecting Protestants' deposits to its operating account to sales tax. It is admitted that Protestants were mainly a cigarette wholesaler. While Protestants did sell other items of tangible personal property; according to the auditor there were not a significant amount of those items, and according to Protestants although they did sell some of these items to their retail customers, they were a huge ticket loss and a majority was either donated to charity or retained by them. No evidence has been produced to show Protestants sold anything to the general public. Further, cigarettes were not subject to sales tax subsequent to January 1, 2005.

10. In the appropriate case, the bank deposits of a taxpayer may serve as substantial evidence of the amount of taxable sales made by such taxpayer. Under the facts and circumstances of this case, the sales tax audit and assessment are not supported by substantial evidence. Accordingly, Protestant's protest should be sustained.

Based on the above and foregoing Findings of Fact and Conclusions of Law the Oklahoma Tax Commission orders the protest of COMPANY and PRESIDENT, as an officer of COMPANY and as an individual be sustained.

OKLAHOMA TAX COMMISSION

CAVEAT: This decision was NOT deemed precedential by the Commission. This means that the legal conclusions are generally applicable or are limited in time and/or effect. Non-precedential decisions are not considered binding upon the Commission. Thus, similar issues may be determined on a case-by-case basis.