

JURISDICTION: OKLAHOMA TAX COMMISSION DECISION  
CITE: 2008-12-02-02 / NON-PRECEDENTIAL  
ID: P-07-086-H  
DATE: DECEMBER 2, 2008  
DISPOSITION: SUSTAINED  
TAX TYPE: SALES  
APPEAL: NO APPEAL TAKEN

### FINDINGS OF FACT AND CONCLUSIONS OF LAW

OWNER d/b/a LIQUOR STORE (“Protestant”) appears through ATTORNEY, Attorney at Law. The Field Audit Section of the Compliance Division (“Division”), Oklahoma Tax Commission, appears through OTC ATTORNEY, Assistant General Counsel, Office of General Counsel, Oklahoma Tax Commission.

### PROCEDURAL HISTORY

On May 30, 2007, the protest file was received by this office for further proceedings consistent with the *Uniform Tax Procedure Code*<sup>1</sup> and the *Rules of Practice and Procedure Before the Oklahoma Tax Commission*.<sup>2</sup> On May 30, 2007, an introductory letter was mailed to the Protestant stating this matter had been assigned to ALJ, Administrative Law Judge, and docketed as Case Number P-07-086-H. The letter also advised the Protestant a Notice of Prehearing Conference would be sent by mail and enclosed a copy of the *Rules of Practice and Procedure Before the Oklahoma Tax Commission*.<sup>3</sup> On June 5, 2007, OTC ATTORNEY filed an Entry of Appearance, as counsel of record for the Division.

On July 3, 2007, the Division filed revised audit work papers. On July 5, 2007, the Notice of Prehearing Conference was mailed to the last-known address of the Protestant, setting the prehearing conference for July 16, 2007, at 2:30 p.m.<sup>4</sup> The prehearing conference was continued at the Protestant’s request because she had retained counsel. The Division did not have an objection to the continuance.

On July 23, 2007, ATTORNEY filed an Entry of Appearance as counsel of record for the Protestant. On July 25, 2007, the Notice of Prehearing Conference was mailed to the parties setting the prehearing conference for August 7, 2007, at 10:30 a.m. The prehearing conference was held as scheduled with the parties in attendance. On August 8, 2007, a letter was mailed directing the parties to file a status report on or before September 6, 2007.

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<sup>1</sup> OKLA. STAT. ANN. tit. 68, § 201 et seq. (West 2001).

<sup>2</sup> OKLA. ADMIN. CODE §§ 710:1-5-20 through 710:1-5-47.

<sup>3</sup> See Note 2.

<sup>4</sup> OKLA. STAT. ANN. tit. 68, § 208 (West 2001). The notice was mailed to the Protestant at MAILING ADDRESS.

On September 6, 2007, OTC ATTORNEY filed the Status Report advising the parties had met that same day and ACCOUNTANT, CPA, was to review the Protestant's business records to determine a beginning and ending inventory for the audit period. On September 10, 2007, the parties were advised by letter a status report was to be filed on or before November 5, 2007. On November 5, 2007, the Division's Status Report was filed advising ACCOUNTANT'S review of the Protestant's business records should be completed in about two (2) weeks, and once completed the Division would need sufficient time to review the documents to determine if any adjustments should be made to the Division's work papers. On November 6, 2007, the parties were advised by letter a status report was to be filed on or before December 5, 2007.

The Procedural History from December 6, 2007, to May 8, 2008, has been omitted herein.

On May 9, 2008, the Division's Status Report was filed requesting this matter be set for hearing. On May 15, 2008, a letter was mailed to the parties setting this matter for hearing on July 1, 2008, at 1:30 p.m., with position letters or memorandum briefs due on or before June 24, 2008.

On June 18, 2008, the Brief of the Compliance Division was filed, with Exhibits A through N attached thereto. On June 24, 2008, the Protestant's Position Letter was filed, with two (2) attachments thereto.

On July 1, 2008, at 1:30 p.m. an open hearing<sup>5</sup> was commenced as scheduled. The Protestant testified on her own behalf about her business practices, business records, and the audit conducted by the Division. The Protestant's Exhibits 2-1, 2-2, and 2-3 were identified, offered, and admitted into evidence.<sup>6</sup>

During the direct examination of the Protestant, Protestant's Exhibit 3 ("Beginning and Ending Inventory") was identified and offered into evidence, but the Division discovered Protestant's Exhibit 3 did not match the Beginning and Ending Inventory which had previously been provided and upon which the Division had revised the proposed sales tax assessment.

The hearing was recessed so the parties could try to reconcile the records, but the parties were unable to do so. Upon reconvening the hearing, the parties requested the hearing be continued to sort out the problem(s) with Protestant's Exhibit 3, which had been prepared by ACCOUNTANT. The parties' oral request for a continuance of the hearing was orally granted for good cause.

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<sup>5</sup> The Protestant, through ATTORNEY, waived her right to a confidential hearing. *See* OKLA. STAT. ANN. tit. 68, § 205 (West Supp. 2008).

<sup>6</sup> The Division's objection to the admission into evidence of Protestant's Exhibit 1 was sustained. Protestant's Exhibit 1 consisted of what was identified as "all of the Protestant's business records" for the audit period. The Division had not been advised prior to hearing of the Protestant's intention to introduce the records, which were voluminous, and the Division had not been given an opportunity prior to hearing to examine the records.

On July 2, 2008, a letter was mailed to the parties confirming the Administrative Law Judge's ruling and directing the parties to file a status report on or before July 31, 2008.

On July 2, 2008, the Division's Request for Production of Documents was filed with the clerk of the court. On July 28, 2008, the Division filed the Status Report requesting the hearing be reset.

On July 31, 2008, the parties were advised by letter the hearing had been reset for September 16, 2008, at 9:30 a.m.

The hearing was re-convened as scheduled on September 16, 2008, at 9:30 a.m., with all parties in attendance. The hearing picked up where it had left off on July 1, 2008, with the direct examination of the Protestant by ATTORNEY.

The Protestant continued to testify about her business practices, business records, and the audit conducted by the Division. The Protestant also called ACCOUNTANT, who testified about his review of the Protestant's business records and his preparation of the Protestant's Beginning and Ending Inventory. The Protestant's Exhibits 1-1, 1-2, 1-3, 3, and 9 were identified, offered, and admitted into evidence.<sup>7</sup> The Division called one (1) witness, AUDITOR, Field Auditor, Field Audit Section of the Compliance Division, Oklahoma Tax Commission, who testified as custodian of the Division's records and the audit. The Division's Exhibits B through E and Exhibits G through P, were identified, offered, and admitted into evidence. Copies of the Protestant's state and federal income tax returns for the 2004 tax year were marked as ALJ's Exhibit 1 at the court's request. Both returns had been revised July 8, 2008, by ACCOUNTANT.

Upon the Division resting its case, ATTORNEY made an oral Motion for Directed Verdict, which was orally denied by the court.<sup>8</sup>

At the conclusion of the hearing, the record in this matter was closed and the case submitted for decision on September 16, 2008.

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<sup>7</sup> The Protestant requested the Administrative Law Judge to reconsider the ruling on the admission into evidence of Protestant's Exhibits 1-1, 1-2, and 1-3 (three (3) boxes), which were identified as the Protestant's business records during the audit period. ATTORNEY gave notice to the Division, through OTC ATTORNEY, of his intention to ask the Administrative Law Judge to reconsider the ruling. The Division was given ample notice and opportunity to examine the records prior to the hearing on September 16, 2008. The Administrative Law Judge reconsidered the ruling and admitted Protestant's Exhibit 1-1, 1-2, and 1-3 into evidence, over the objection of the Division.

<sup>8</sup> OKLA. STAT. ANN. tit. 12, § 577 (West Supp. 2008). The Administrative Law Judge referred ATTORNEY to the *Rules of Practice and Procedure Before the Oklahoma Tax Commission*, which does not contain a provision permitting a Motion for Directed Verdict. ATTORNEY was referred to OKLA. ADMIN. CODE § 710:1-5-39 (June 25, 1999), which requires the Administrative Law Judge to issue Findings of Fact, Conclusions of Law, and Recommendations.

**FINDINGS OF FACT**

Upon review of the file and records, including the record of the proceedings, the exhibits received into evidence, position letter, and brief, the undersigned finds:

1. At the conclusion of the hearing, it came to the attention of the court that Protestant's true and correct name is OWNER. All references to Protestant are corrected to read accordingly.

2. The Protestant operates a retail liquor store at BUSINESS ADDRESS. The business is a sole proprietorship. On or about July 1, 2003, the Protestant opened for business at the current location, which is approximately 1000 sq. feet to 1100 sq. feet in size.<sup>9</sup>

3. The Protestant was selected for a field audit covering the period of January 1, 2004, through September 30, 2006 ("Audit Period").

4. AUDITOR was assigned to assist and train LEAD AUDITOR("Lead Auditor") in the field audit of the Protestant. The Lead Auditor was new and inexperienced.<sup>10</sup>

5. On December 15, 2006, the Protestant signed an "Assessment and Refund Statute of Limitation Waiver Agreement" extending the statutory period for assessment and refund to June 30, 2007.<sup>11</sup>

6. On December 15, 2006, the Division faxed Protestant the Division's "Records Request" for the Audit Period,<sup>12</sup> which requested the following records, to-wit:

- (1) Beginning Inventory as of 01/01/04.
- (2) Ending Inventory as of 09/30/06.
- (3) Provide all liquor invoices for 01/01/04 through 09/30/06.
- (4) Provide all purchases invoices and receipts for the Audit Period indicated.
- (5) Provide all daily sales reports or receipts for the Audit Period indicated.
- (6) All monthly reports for the Audit Period indicated and register tapes for ~~April~~ *July 2004, October December 2005, and July August 2006.* (Emphasis added.)
- (7) Show how the reported sales were calculated for sales tax.
- (8) Provide balance sheets, income statements and bank statements for the Audit Period indicated.
- (9) Provide the 2004 and 2005 federal and state income tax returns.

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<sup>9</sup> Testimony of Protestant.

<sup>10</sup> Testimony of AUDITOR. No explanation was offered as to why the Lead Auditor did not appear or testify at hearing.

<sup>11</sup> Division's Exhibit B. The document was signed by the Protestant and Lead Auditor.

<sup>12</sup> Division's Exhibit C.

- (10) If you have any employees, provide our W-2's, 941's, OESC's, 1099's, OTC withholding reports, and your payroll records for the Audit Period.
- (11) Police report or insurance report for any loss of liquor during the Audit Period.
- (12) Provide a copy of any Letter Ruling, Opinion, or Order from the Commission received during the Audit Period.
- (13) A copy of your ABLE license.

7. The Division did not include a request for the Protestant to complete a percent mark-up sheet providing ranges of mark-ups for each size of spirits, wine, and strong beer, and any specials or discounts during the Audit Period.<sup>13</sup>

8. The Division did not have the Protestant execute an Audit Methodology Agreement consenting to the use of the "Cost Mark-Up Depletion Method" to conduct the audit. The Protestant was not given the opportunity to agree to the Sample Months chosen by the Lead Auditor, nor the method the Lead Auditor used to determine the "Wholesale Costs" and "Retail Prices," which were used to calculate the "Average Percent Mark-Up."<sup>14</sup>

9. On December 27, 2006, the Division received records from categories three (3), six (6), eight (8), nine (9), and thirteen (13) of the Records Request.<sup>15</sup>

10. The Division obtained the Protestant's purchase records from wholesalers for the Audit Period, with the exception of DISTRIBUTOR 2004 purchases, which had gone out of business. The Protestant provided the Division with the DISTRIBUTOR purchase invoices for 2004.<sup>16</sup>

11. The Lead Auditor and an un-named auditor conducted a "Price Survey" at the Protestant's business. The exact date and particulars of the survey are unclear because the Price Survey was not identified, offered, and admitted into evidence. The Division relied on a summary prepared by the Lead Auditor on January 7, 2007, which contained the information used by the Lead Auditor to calculate a straight "Average Percent Mark-Up" for the Audit Period, instead of a "Weighted Average Percent Mark-Up."<sup>17</sup>

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<sup>13</sup> AUDITOR testified the Protestant stated during a telephone conversation her Average Percent Mark-Up was 30%, but on cross-examination AUDITOR was presented with part of the audit write-up dated December 27, 2006, indicating the mark-up for liquor was 15-20%, strong beer was 20%, and wine was 20-25%. The Protestant denied every stating her mark-up was 30%.

<sup>14</sup> Testimony of Protestant and AUDITOR.

<sup>15</sup> See Note 12.

<sup>16</sup> Division's Exhibit D.

<sup>17</sup> Testimony of AUDITOR. Division's Exhibit E.

12. From a review of the Protestant's "Business Records,"<sup>18</sup> the "Wholesale Costs" were determined from the purchase invoices for the Sample Months of July 2004, December 2005, and August 2006.<sup>19</sup> It also appears from a review of the Protestant's Business Records, the Lead Auditor used the highest Wholesale Cost for each category during the Sample Months.<sup>20</sup>

13. On January 5, 2007, the Lead Auditor prepared an "Average Percent Mark-Up"<sup>21</sup> (Wholesale Cost versus Retail Price) using forty (40) bottles of Wines and Spirits and three (3) Strong Beer products (two 6 packs and one 12 pack), resulting in a "Average Percent Mark-up" of 22.46% for the Audit Period. At any one time, the Protestant has approximately 6000 to 6500 products on display and for sale.<sup>22</sup>

14. The Division compared the Protestant's sales reported on her federal income tax returns, sales reported to the Tax Commission, and purchases during the Audit Period. The Protestant did not supply a Beginning and Ending Inventory for the Audit Period. The comparison reflected the sales tax reports for the Audit Period were more than the sales on the federal income tax returns, but purchases were more than reported on the Protestant's federal income tax returns. The Division concluded the Protestant's federal income tax returns did not supply adequate information to determine sales for the Audit Period.<sup>23</sup>

15. The Division prepared a schedule of "Bank Deposits" for the Audit Period which reflected reported sales were \$220,325.02 greater than deposits.<sup>24</sup> The Division concluded it could not rely on the bank statements to determine sales for the Audit Period.<sup>25</sup>

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<sup>18</sup> Protestant's Exhibits 1-1, 1-2, and 1-3.

<sup>19</sup> Testimony of AUDITOR. AUDITOR testified the Wholesale Costs came from the Protestant's business records for the Audit Period, but she could not identify what invoices were used and the month(s) from the Audit Period. No document was offered, identified, and admitted into evidence which reflects how the Lead Auditor determined the Wholesale Costs.

<sup>20</sup> See Note 18.

<sup>21</sup> Division's Exhibit E. AUDITOR testified a sample of 43 products was sufficient to determine the Average Percent Mark-Up for a liquor store the size of the Protestant's and if an audit of a large operation, like LARGE LIQUOR STORE, was conducted, a sample of approximately 100 bottles should be sufficient. To demonstrate the inaccuracy of the Division's sample, the Protestant introduced evidence which indicated the Division's sample size in relation to total purchases during the Audit Period yielded an accuracy level of approximately 14.91%. See Protestant's Exhibit 9, Page 13.

<sup>22</sup> Testimony of Protestant. The Protestant cannot maintain a substantial inventory due to the cost. Almost all of the products are on the floor and displayed for sale. Because of the Protestant's low cash flow, the Protestant has a one hundred percent (100%) turn over in inventory each month.

<sup>23</sup> Division's Exhibit H. Testimony of AUDITOR. ACCOUNTANT testified he "revised" the Protestant's state and federal income tax returns after the audit was completed. See Protestant's Exhibits 2-1, 2-2, 2-3, and ALJ's Exhibit 1.

<sup>24</sup> Division Exhibit I.

<sup>25</sup> Testimony of AUDITOR.

16. The Division examined the Protestant's "Z-Tapes" for the Sample Months and compared the results to the sales reported to the Tax Commission for the same months. The Division's comparison reflected nominal differences.<sup>26</sup> However, ACCOUNTANT'S review reflected numerous errors made by the Division in its comparison. The Protestant's Z-Tapes for the Sample Months and the "Sales Tax Reports" for the Sample Months matched.<sup>27</sup>

17. The Division found numerous purchase invoices marked "Paid Cash" and concluded the computation of expected sales based on wholesale purchases and the Average Percent Mark-Up was the most accurate method of calculating sales.<sup>28</sup>

18. Based upon an Average Percent Mark-Up of 22.46%, the Lead Auditor compared the total purchases and total sales for the Audit Period. Based upon this comparison, there were under-reported sales of \$155,622.20 for the Audit Period.<sup>29</sup>

19. On January 18, 2007, the Protestant signed a copy of the Division's work papers ("First Work Papers"). The Protestant's signature only acknowledged receipt of the 1<sup>st</sup> Work Papers. The Protestant did not agree with the amount of under-reported sales.<sup>30</sup>

20. On February 20, 2007, the Division issued the proposed sales tax assessment<sup>31</sup> against the Protestant for the Audit Period, as follows, to-wit:

Tax Due:	\$13,227.89
Interest @ 15% through 03/31/07:	3,553.57
Tax & Interest Due Within 30 Days:	\$16,781.46
30 Day Delinquent Penalty @ 10%:	1,322.79
Tax, Interest & Penalty Due After 30 Days:	\$18,104.25

21. On April 10, 2007, the Division received a timely filed protest to the proposed sales tax assessment.<sup>32</sup>

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<sup>26</sup> Division's Exhibit J. See Division's Exhibit C. AUDITOR testified the Z-Tapes were sampled to determine whether a detail audit was necessary. Since there were nominal differences a detail audit of the Z-Tapes was not necessary.

<sup>27</sup> Protestant's Exhibit 9, Pages 35-40.

<sup>28</sup> Testimony of AUDITOR. The Protestant also testified it was a normal practice for her to take cash from the register to purchase products. The Protestant testified most of her products are purchased with cash or a check. The wholesalers do not extend credit to the Protestant.

<sup>29</sup> Division's Exhibit G.

<sup>30</sup> See Note 29.

<sup>31</sup> Division's Exhibit K.

<sup>32</sup> Division's Exhibit L.

22. On June 20, 2007, the Division issued work papers (“2nd Work Papers”)<sup>33</sup> to reflect a two percent (2%) allowance<sup>34</sup> for spoilage, breakage, theft, etc. resulting in under-reported sales of \$152,509.76.

23. On February 7, 2008, the Protestant submitted a Beginning Inventory (\$28,661.84) and Ending Inventory (\$35,991.88)<sup>35</sup> prepared by ACCOUNTANT from his review of the Protestant’s Business Records<sup>36</sup> for the Audit Period. The Division accepted the Beginning and Ending Inventory prepared by ACCOUNTANT.<sup>37</sup>

24. On March 12, 2008, the Division issued revised work papers (“3<sup>rd</sup> Work Papers”)<sup>38</sup> to correct a calculation error on the 2<sup>nd</sup> Work Papers regarding the two percent (2%) allowance resulting in under-reported sales of \$143,333.65.

25. On March 31, 2008, the Division issued revised work papers (“4<sup>th</sup> Work Papers”)<sup>39</sup> to allow the Beginning and Ending Inventory, resulting in under-reported sales of \$134,536.82.

26. On July 21, 2008, the Division issued revised work papers (“5<sup>th</sup> Work Papers”)<sup>40</sup> to give the Protestant credit for the timely filed September 2006 sales tax report and payment, resulting in under-reported sales of \$121,893.82, which were calculated as follows, to-wit:

Beginning Inventory:	\$ 28,661.84
Plus Purchases:	501,737.06
Minus Ending Inventory:	<u>35,991.88</u>
Available Inventory:	\$494,407.02
Times Average Percent Mark-up (22.46%):	605,450.84
Minus 2% Allowance:	12,109.02
Minus Reported Sales:	<u>471,448.00</u>
Total Under-Reported Sales:	\$121,893.82

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<sup>33</sup> Division’s Exhibit M.

<sup>34</sup> See OTC Order No. 2007-06-05-04 (June 5, 2007).

<sup>35</sup> Protestant’s Exhibit 3.

<sup>36</sup> Protestant’s Exhibit 1.

<sup>37</sup> Protestant’s Exhibit 9, Page 17.

<sup>38</sup> Division’s Exhibit N. See Note 34.

<sup>39</sup> Division’s Exhibit O.

<sup>40</sup> Division’s Exhibit P. The Division’s records mistakenly reflected the Protestant had not filed the September 2006 sales tax report and remitted the tax due.

27. The Division's 5<sup>th</sup> Work Papers result in a proposed sales tax assessment<sup>41</sup> against the Protestant, as follows, to-wit:

Tax Due:	\$ 10,360.97
Interest @ 15% through 07/31/08:	5,874.00
Penalty @ 10%:	<u>1,036.09</u>
Tax, Interest & Penalty:	\$ 17,271.06

28. The Protestant's business was losing money during the Audit Period,<sup>42</sup> as follows, to-wit:

Beginning Inventory:	\$ 28,662.00 <sup>43</sup>
Plus Purchases:	504,617.00 <sup>44</sup>
Minus Ending Inventory:	<u>35,992.00</u>
Cost of Goods Sold:	\$497,287.00
Sales:	\$472,958.00 <sup>45</sup>
Cost of Goods Sold:	<u>497,287.00</u>
Gross Profit Margin:	\$ (24,329.00)
Divided by Sales:	472,287.00
Gross Profit Margin Ratio:	(5.14 %)

### CONCLUSIONS OF LAW

1. The Oklahoma Tax Commission is vested with jurisdiction over the parties and subject matter of this proceeding.<sup>46</sup>

2. The collection and remittance of sales tax is governed by the Oklahoma Sales Tax Code ("Sales Tax Code").<sup>47</sup> The Sales Tax Code levies "upon all sales,<sup>48</sup> not otherwise

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<sup>41</sup> See Note 40.

<sup>42</sup> See Notes 37 and 40. The Protestant testified she was using her credit card like a check to provide additional funds and she had taken out a second mortgage on her residence to keep the business afloat, but it has not worked. Protestant also testified she knew the business was struggling day-to-day, but because of the audit, she learned the business was losing money. The Protestant's calculation, prepared by ACCOUNTANT, does not include the business expenses for the Audit Period.

<sup>43</sup> The figures were rounded up or down to the nearest dollar.

<sup>44</sup> See Notes 37 and 40. The Protestant's Business Records reflect \$2,880.00 more in purchases than the Division's records.

<sup>45</sup> See Notes 37 and 40. The Protestant's Business Records reflect \$1,510.00 more in sales than the Division's records.

<sup>46</sup> OKLA. STAT. ANN. tit. 68, § 221(D) (West Supp. 2008).

<sup>47</sup> OKLA. STAT. tit. 68, § 1350 et seq. (West 2001).

exempted . . . an excise tax of four and one-half percent (4.5%) of the gross receipts or gross proceeds<sup>49</sup> of each sale of . . . tangible personal property. . . .”<sup>50</sup> Oklahoma Statutes authorize incorporated cities, towns, and counties to levy taxes as the Legislature may levy and collect taxes for purposes of state government.<sup>51</sup>

3. The sale of “[f]ood . . . , and all drinks sold or dispensed by hotels, restaurants, or other dispensers, and sold for immediate consumption . . . delivered or carried away from the premises for consumption elsewhere” is expressly made subject to sales tax.<sup>52</sup>

4. The Tax Commission has promulgated rules as provided by law to facilitate the administration, enforcement, and collection of sales tax pursuant to the Sales Tax Code.<sup>53</sup>

5. The rules promulgated pursuant to the Administrative Procedures Act are presumed to be valid and binding on the persons they affect and have the force of law.<sup>54</sup>

6. An auditor for the Commission may suggest a sample sales/use tax audit rather than a detailed audit. The auditor shall select the periods to sample and apply the results to all the periods of the audit. The auditor shall prepare forms to be signed by the taxpayer stating they agree with the periods and method chosen for the sample.<sup>55</sup>

7. In sales tax matters, “[t]he burden of proving a sale was not a taxable sale shall be upon the person who made the sale.”<sup>56</sup>

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<sup>48</sup> OKLA. STAT. tit. 68, § 1352(15)(a) (West 2001) and (as amended) OKLA. STAT. tit. 68, § 1352(21)(a) (West Supp. 2006):

"Sale" means the transfer of either title or possession of tangible personal property for a valuable consideration regardless of the manner, method, instrumentality, or device by which the transfer is accomplished in this state, or other transactions as provided by this paragraph, including but not limited to:

a. the exchange, barter, lease, or rental of tangible personal property resulting in the transfer of the title to or possession of the property,

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<sup>49</sup> OKLA. STAT. tit. 68, § 1352(7) (West 2001) and (as amended) OKLA. STAT. tit. 68, § 1352(11) (West Supp. 2006).

<sup>50</sup> OKLA. STAT. tit. 68, § 1354(A)(1) (West Supp. 2006).

<sup>51</sup> OKLA. STAT. tit. 68, § 1370 et seq. (West Supp. 2006) and OKLA. STAT. tit. 68, § 2701 (West Supp. 2006).

<sup>52</sup> OKLA. STAT. tit. 68, § 1354(A)(9) (West 2001).

<sup>53</sup> OKLA. STAT. tit. 68, § 1350 et seq. (West 2001).

<sup>54</sup> OKLA. STAT. ANN. tit. 75, § 250 et seq. (West 2001).

<sup>55</sup> OKLA. ADMIN. CODE § 710:65-5-2. *See* OKLA. STAT. ANN. tit. 68, § 206 (West 2001).

<sup>56</sup> OKLA. STAT. ANN. tit. 68, § 1365(F) (West Supp. 2007):

8. In all proceedings before the Tax Commission, the taxpayer has the burden of proof.<sup>57</sup> A proposed assessment is presumed correct and the taxpayer bears the burden of showing that it is incorrect and in what respects.<sup>58</sup>

9. An order of the Tax Commission must be supported by substantial evidence.<sup>59</sup> Likewise, the audit upon which a portion of the record is formed and order issued, must be supported by substantial evidence.<sup>60</sup>

## DISCUSSION

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It shall be the duty of every tax remitter required to make a sales tax report and pay any tax under Section 1350 et seq. of this title to keep and preserve suitable records of the gross daily sales together with invoices of purchases and sales, bills of lading, bills of sale and other pertinent records and documents which may be necessary to determine the amount of tax due hereunder and such other records of goods, wares and merchandise, and other subjects of taxation under Section 1350 et seq. of this title as will substantiate and prove the accuracy of such returns. It shall also be the duty of every person who makes sales for resale to keep records of such sales which shall be subject to examination by the Tax Commission or any authorized employee thereof while engaged in checking or auditing the records of any person required to make a report under the terms of Section 1350 et seq. of this title. All such records shall remain in Oklahoma and be preserved for a period of three (3) years, unless the Tax Commission, in writing, has authorized their destruction or disposal at an earlier date, and shall be open to examination at any time by the Tax Commission or by any of its duly authorized agents. The burden of proving that a sale was not a taxable sale shall be upon the person who made the sale.

<sup>57</sup> OKLA. ADMIN. CODE § 710:1-5-47 (June 25, 1999):

In all administrative proceedings, unless otherwise provided by law, the burden of proof shall be upon the protestant to show in what respect the action or proposed action of the Tax Commission is incorrect. If, upon hearing, the protestant fails to prove a prima facie case, the Administrative Law Judge may recommend that the Commission deny the protest solely upon the grounds of failure to prove sufficient facts which would entitle the protestant to the requested relief.

OKLA. ADMIN. CODE § 710:1-5-77(b) (June 25, 1999), provides in pertinent part:

... “preponderance of the evidence” means the evidence which is of greater weight or more convincing than the evidence which is offered in opposition to it; evidence which as a whole shows that the fact sought to be proved is more probable than not.

<sup>58</sup> See *Enterprise Management Consultants, Inc. v. State ex rel. Oklahoma Tax Com’n*, 1988 OK 91, 768 P.2d 359.

<sup>59</sup> *Dugger v. State ex rel. Oklahoma Tax Com’n*, 1992 OK 105, 834 P.2d 964.

<sup>60</sup> Commission Order No. 2003-07-22-09 (July 22, 2003), 2003 WL 2347117 (Okl. Tax Com.), available at <http://westlaw.com>

The Protestant's primary contentions are twofold: first, whether the Division violated Tax Commission Rule 710:65-5-2 by conducting a "Cost Mark-up Depletion Audit"; and second, the Protestant's business records for the Audit Period were sufficient for the Division to determine the accuracy of the Protestant's Reported Sales.

As to the Protestant's first contention, the Division asserts that it is not in violation of Tax Commission Rule 710:65-5-2 because the audit is a "Detailed Audit" and not a "Projection Audit" or "Sample Audit."

The Division also disputes the Protestant's second contention. In its brief, the Division states as follows, to-wit:

The Division found inconsistency in the income tax returns, sales tax reports, purchase information provided by the Protestant, bank deposits and the daily register tapes (z tapes). Therefore, the Division concluded that the expected sales based on wholesale purchases and average percent markup percentage was the most accurate method of calculating the sales for the audit period.

As to the Protestant's first contention, the Tax Commission has addressed the parties' dispute regarding the "Cost Mark-Up Depletion Method" in OTC Order No. 2006-12-07-04 (December 7, 2006), cited by the Protestant, which states in pertinent part, as follows, to-wit:

Notwithstanding the Division's contention that the audit performed on Protestant's business is different than a projection audit, the fact is the auditor both as to substance and in form employed a projection method without Protestant's written authorization with respect to the sample periods and the sampling method. Such action is in violation of OAC, 710:65-5-2 and prevents the audit herein from providing the substantial evidence necessary for an assessment of additional sales tax in this matter.

The Division conducted a "Cost Mark-Up Depletion Audit" on the Protestant for the Audit Period. The Tax Commission has approved the use of this type of method to audit retail package liquor stores, but in this matter the Protestant did not consent to the use of this method by signing an Audit Methodology Agreement.<sup>61</sup> The Protestant was also not afforded an opportunity to agree to the Sample Months chosen by the Lead Auditor, nor the method chosen by the Auditor to determine the wholesale costs and retail prices.<sup>62</sup>

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<sup>61</sup> OTC Order No. 2006-12-07-04 (December 7, 2006). In stark contrast to the cited order and this matter, a review of OTC Order No. 2008-07-29-25 (July 29, 2008) illustrates the Division's successful use of a "Cost Mark-Up Depletion Audit" on a retail liquor store. The Protestant in that case signed an Audit Methodology Agreement and the protest was denied because the Protestant could not meet his burden of proof.

<sup>62</sup> Even if the Protestant had signed an Audit Methodology Agreement, the Division's determination of the Average Percent Mark-Up is still flawed in several respects, including the limited size of the sample used for the Audit Period. Using an accounting approach, ACCOUNTANT was able to show the Protestant lost money during the Audit Period. The calculations do not include any of the business expenses incurred during the Audit Period.

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. Where, however, 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.<sup>63</sup>

An evidentiary foundation has not been laid for the audit and assessment in this matter because the Division did not have the Protestant sign an Audit Methodology Agreement consenting to the use of the “Cost Mark-Up Depletion Method” to conduct the audit.

### **DISPOSITION**

It is the ORDER of the OKLAHOMA TAX COMMISSION, based upon the facts and circumstances of this case, the protest to the proposed sales tax assessment (5<sup>th</sup> Work Papers) should 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.

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<sup>63</sup> See Note 62.