Sales Tax and Internal Controls

By Stuart M. Bordman

One of our firm's long-term major clients is a petroleum wholesaler and retailer. At the retail level, profit is not in the sale of gasoline, but rather from the convenience store ("C Store"). Like other retailers, sales tax must be collected and remitted. Our client recently referred one of his retail customers to our office. The customer owns four retail sites – each in a separate corporation, each with a C Store. Over the years, the corporations have been regularly audited by the Michigan Department of Treasury ("Treasury") for sales tax. The issue was the same in each case: determining the amount of the exemption from sales tax for "food or food ingredients, except prepared food intended for immediate human consumption" ("Food"). In the case at issue, a first-time tax auditor determined that a substantial amount of sales tax was due together with a penalty equal to 10% of the tax due.

The client, before our involvement, participated in an informal conference with the Treasury. The Informal Conference Recommendation (ICR) stated that the primary cause of deficiency was overstatement of Food as a percentage of sales. The ICR went on to state that the client lacked electronic records; had weak internal controls and lacked adequate controls to ensure integrity in the sales reporting process. The ICR did not raise the issue of underreported sales.

At our insistence, the client retained an accountant who reviewed the ICR and the underlying audit report. Based upon purchase records and gross profit margins, the accountant determined that sales of Food were greater than that in the ICR. While the client believes that all sales tax due was paid, they recognize that the records necessary to establish the exemption for Food are inadequate. Records were not maintained electronically and paper records were not retained. Our client's frustration results from the fact that they maintained the same records and internal controls at each retail site and the audits of the other corporations resulted in nominal assessments.

Upon receipt of the Assessment from the Treasury, a portion of the deficiency was paid and we filed a petition with the Michigan Tax Tribunal ("MTT"). Rules of the

MTT require the taxpayer to pay the amount which they believe is due. Our petition requests the elimination of the unpaid portion of the assessment and elimination of the penalty.

We instructed our client to implement internal controls and utilize electronic records in order to resolve matters at the auditor level in the future.

The audit presented no tax or legal issues. Success depends upon records and the audit trail. The sole issue is whether the taxpayer has adequate records and internal controls to support the exemption for the sale of Food.

Will your client pay sales tax not due because internal controls are lacking and records are inadequate? Will they end up before the MTT? Take action now to save your client money and grief.

For more information about this issue, please call me at 248.827.1870 or sbordman@maddinhauser.com.