STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition of GREENVILLE PHARMACY, INC. and William Quackenbush, President for Revision of a Determination or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period June 1, 1979 through November 30, 1982.	DECISION

Petitioners, Greenville Pharmacy, Inc. and William Quackenbush, President, The Country Plaza, Route 32, Greenville, New York 12083, filed a petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period June 1, 1979 through November 30, 1982 (File Nos. 48713 and 48714).

A hearing was held before Brian L. Friedman, Hearing Officer, at the offices of the State Tax Commission, Building #9, W. A. Harriman Campus, Albany, New York, on November 20, 1985 at 1:15 P.M., with all briefs to be submitted by February 12, 1986. Petitioners appeared by Thomas W. Lewis, Esq. The Audit Division appeared by John P. Dugan, Esq. (Thomas Sacca, Esq., of counsel).

ISSUES

I. Whether the Audit Division's use of a representative test period audit method as a basis for determining taxable sales was proper.

II. Whether the additional sales tax assessed as the result of such an audit accurately reflects the taxes due.

FINDINGS OF FACT

1. Petitioner, Greenville Pharmacy, Inc. ("Greenville"), operated a drugstore selling a full line of health and beauty aids, cards and gift wrap and other sundries, as well as prescription drugs.

2. William T. Quackenbush, as President of Greenville, executed two consents extending the period of limitation for assessment of sales and use taxes for the period December 1, 1979 through February 29, 1980 to December 20, 1983 and for the period March 1, 1980 through May 31, 1980 to December 20, 1983.

3. On November 4, 1983, as the result of an audit, the Audit Division issued a Notice of Determination and Demand for Payment of Sales and Use Taxes Due against Greenville covering the period June 1, 1979[1] through November 30, 1982 for taxes due of $10,039.52 plus interest. On the same date, a similar notice was issued against William T. Quackenbush, as an officer of Greenville, covering the same periods but asserting taxes due of $10,025.52 plus interest. A use tax of $14.00 was asserted against Greenville, but not against Mr. Quackenbush as officer.

4. Greenville filed a tax return for the period September 1, 1981 through November 30, 1981 taking a credit of $3,963.33 on reported sales and use taxes due of $7,580.23. At hearing, the Audit Division conceded that Greenville was entitled to a credit of $3,318.95. The overpayment resulted from Greenville's practice of erroneously including sales tax collected in the category of

1 Although the audit period included sales tax quarters ended August 31, 1979 and November 30, 1979, these quarters were outside the statute of limitation. The notices assess tax only for those quarters within the statute.

reported taxable sales and services during the period June 1, 1979 through May 31, 1981.

5. On audit, Greenville's books and records were deemed to be in good condition and adequate for the purpose of conducting a detailed audit requiring the actual examination and inspection of all sales or purchase invoices or other records of the audit period. After being so informed, Mr. Quackenbush, as President of Greenville, executed an Audit Method Election form, agreeing to the utilization of a representative test period audit method to determine any sales or use tax liability. The parties agreed that a detailed fixed asset acquisitions audit would be performed separately.

6. From Greenville's disbursement journals, the auditor calculated total gross purchases for the test period of $755,332.00. From this figure, she subtracted $10,020.00 which represents an inventory build-up of unsold purchases per Greenville's records. The auditor analyzed purchase invoices for a one year period from October 1, 1980 through September 30, 1981. Invoices were not available for this period from the McKesson Drug Corporation ("McKesson"), Greenville's major supplier of health and beauty aids; consequently, McKesson invoices for the prior year were used. All purchases were divided into the following categories: prescriptions, drugs, sundry, cards, candy, papers, magazines and tobacco. Using totals from each category, the auditor determined that taxable purchases amounted to 46.13 percent of all sales or $343,812.00. The auditor next calculated a markup of 49.48 percent by dividing taxable purchases into total taxable sales. The latter figure was also derived from an analysis of purchase invoices. Application of the markup figure to taxable purchases resulted in gross audited taxable sales of $513,930.00. After deducting .5 percent from this figure to allow for pilferage, the auditor next

calculated unreported (additional) taxable sales of $28,828.00 by subtracting reported taxable sales ($482,532.00) from net audited taxable sales ($511,360.00). Finally, the auditor calculated an error rate of 5.97 percent by dividing reported taxable sales into additional taxable sales. Taxable sales reported by petitioner for each quarterly period under consideration were increased by this error rate. Taxable sales as so increased less taxable sales reported resulted in audited (unreported) taxable sales on which sales tax of $10,025.52 was due. The Audit Division also assessed a use tax of $14.00 against Greenville for fixed asset acquisitions, which amount is not in dispute.

7. Greenville provided the Audit Division with sales tax returns and related worksheets, Federal and State income tax returns, depreciation schedules, cash receipts journals, check disbursements journal and purchase invoices. Greenville's purchase records and reported gross sales were in substantial agreement with federal tax returns filed during the audit period. Those returns showed an average markup on all goods sold of 39 percent.

8. Greenville maintained cash register tapes; however, they were not utilized in the audit. The tapes showed each individual sale. Cashiers were responsible for segregating taxable and non-taxable items and charging the applicable sales tax. At the end of each day, each register generated a report of total sales, prescription sales, drug sales, sundry items, cards, candy, newspapers, magazines, taxable sales, non-taxable sales, sales tax charged, payments and deposits. This information was transferred to ledger sheets which were used to calculate sales taxes due.

9. Greenville purchased the bulk of its health and beauty aids and many sundries from McKesson which sponsored two advertising programs to assist its retailers in attracting business. The "Great Value" program consisted of a

monthly sale of approximately 40 health and beauty items. To advertise the sale, McKesson provided Greenville with a four-page advertising flyer which could be inserted in local newspapers or stuffed into a shopping bag. All of McKesson's customers participated in the "Great Value" program. The "Value-Rite" program offered eleven sales a year only to participating Value-Rite independent pharmacies. Through this program, McKesson made available health and beauty aids and other products, such as foodstuffs, to which an independent retailer would not normally have access. McKesson provided Greenville with eight to twelve pages of full-page newspaper copy to advertise the sale of approximately 170 items. The markup used in both programs was 10 percent. McKesson had full responsibility for setting up these programs, selecting the sale items and the prices at which they were offered and supplying advertising flyers and ad copy. The programs were designed to enable independent pharmacies to compete with large discount chain stores by giving the public the impression that the independent stores could offer bargains comparable to the larger chains. Greenville conducted its own sales in addition to the McKesson programs. Six times per year, Greenville held sidewalk sales in conjunction with other stores in the shopping mall where it was located. After each major holiday (Christmas, Valentine's Day, Easter, Halloween, etc.), Greenville held a one-half price sale on Hallmark cards, gift wrap, decorations and associated holiday items. In addition to these major sales, Greenville maintained a constant bargain table for "end caps," i.e., damaged, discontinued and slow-moving items.

10. The markup test conducted by the Audit Division utilized some sale prices; however, the test did not consider a sufficient number of sale items, did not recognize all sales programs and did not give sufficient weight to the volume of items sold in these sale programs. The health and beauty aids listed

in the Value-Rite advertising flyers were purchased from McKesson, while other sundries were purchased from Value-Rite (a company owned by McKesson). If an item sold to Greenville by McKesson was included in a Value-Rite promotion, a "V" appeared next to the item on the McKesson invoice. The retail price shown on the invoice represented the everyday Greenville price. The sale price could only be determined through reference to a "Value-Rite" advertising flyer. The auditor gave no consideration to this practice. She did utilize the sale price, as shown in the corresponding advertising flyers whenever an item appeared on a McKesson invoice with an ampersand next to the retail price. In fact, the ampersand denoted that the price shown was a "default price," a retail price calculated by McKesson's computer based on an agreed upon standard markup. The "default price" was used if neither a manufacturer's suggested price nor a pre-selected Greenville price (also called a "unique retail") was available.

11. Greenville offered discounts of twenty percent to all employees on all taxable items. The head of each department was allowed to purchase items in her or his department at cost. Clergymen, dentists and medical doctors working in the Greenville area were allowed to purchase items at the average wholesale price. The markup test did not reflect these practices.

CONCLUSIONS OF LAW

A. That the petitioners cannot object to the Audit Division's use of a representative test period and percentage markup audit since they voluntarily elected to have this method used. Furthermore, the cash register tapes maintained by petitioners and the general ledger prepared from the tapes were useless for verifying taxable sales reported because it could not be determined from these sources if sales tax was charged on all taxable items. Under such circumstances, the alternative was to determine taxable sales from external indices such as purchases in accordance with section 1138(a) of the Tax Law (Matter of Licata v. Chu, 64 N.Y.2d 873).

B. That when books and records are insufficient, test period and percentage markup audits are permissible (Matter of Chartair, Inc. v. State Tax Comm., 65 A.D.2d 44). The audit procedures described in Finding of Fact "6" are generally accepted procedures established by the Audit Division to determine the accuracy of books and records. These procedures disclosed significant underreporting of taxable sales further establishing the unreliability of Greenville's books and records (Matter of Korba v. New York State Tax Comm., 84 A.D.2d 655).

C. That the markup test performed by the Audit Division did not give adequate consideration to the sale programs and discount programs conducted by Greenville. Accordingly, the markup on taxable items is reduced to 45 percent. Moreover, the tax assessed is reduced by $3,318.95 to reflect an overpayment of taxes as described in Finding of Fact "4". In all other respects, the petitioners have failed to show that the method of audit or the amount of tax assessed was erroneous (Matter of Surface Line Operators Fraternal Organization v. Tully, 85 A.D.2d 858).

D. That the petition of Greenville Pharmacy, Inc. and William T. Quackenbush, as President, is granted to the extent indicated in Conclusion of Law "C"; the Audit Division is directed to modify the notices of determination and demands for payment of sales and use taxes due issued November 14, 1983; and, except as so granted, the petition is in all other respects denied.

DATED: Albany, New York

JUN 17 1986

STATE TAX COMMISSION

PRESIDENT

COMMISSIONER

COMMISSIONER