RECENT CONNECTICUT CASE RAISES THE BAR FOR SMALL BUSINESS RECORDKEEPING REQUIREMENTS[1]

CASE ALSO STRUCK COMMISSIONER'S JEOPARDY ASSESSMENT

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On March 17, 2009, the Tax Session of the Connecticut Superior Court ruled that summary tapes from cash registers, commonly referred to as "Z Tapes", were not equivalent to cash register tapes and therefore were not sufficient to meet the taxpayer's burden of maintaining records as required under the Connecticut Regulations. In addition, the court concluded that a jeopardy assessment issued by the Commissioner, which is not based upon facts sufficient to find that tax collection was in jeopardy, is invalid.

The Case

The taxpayer, who owned and operated a night club, was audited for sales tax for October 1, 1999 through March 31, 2005. The auditor, after the initial conference, did not return for over a year, at which time he requested the taxpayer sign a consent to extend the statute of limitations. When the taxpayer refused to sign the extension, the Department of Revenue Services ("DRS") closed the audit, issued a jeopardy assessment, and filed liens against his personal and business properties, treating him as if he would

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abscond without paying the tax. The DRS typically furnishes the taxpayer a period of 60 days to file an appeal and, after concluding the appeal, may then file a lien and take collection action to recover the tax. Here, the Commissioner's use of the jeopardy assessment allowed the DRS to accelerate the filing of the lien. The DRS then issued a tax warrant and sent a state marshal to demand full payment of almost $280,000 immediately.

Recordkeeping, "Z Tapes" and the Regulation

Taxpayers with businesses are required to maintain records to support deductions taken against their sales. Many retail shops, bars and restaurants have modern cash registers which generate cash register receipts at the end of the business day that show each transaction that day. In addition, the registers generate a summary tape of the day's activity, referred to as a "Z Tape." Business owners, as well as their accountants - until now - generally believed that the Z Tapes were sufficient to meet the recordkeeping requirement of the state regulation.

The Court, however, decided that Z Tapes are not sufficient to meet the records requirement set by Connecticut Regulations, and that without the actual cash register tapes showing the individual transactions, the DRS may use its own method for determining the taxpayer's income.

Connecticut Agency Regulation § 12-2-12(b)(1) states that:

> "A taxpayer shall maintain all records that are necessary to a determination of correct tax liability under the affected tax law provisions. All required records shall be made available upon request by the

> commissioner or his authorized representatives as provided for in the affected tax law provisions. Such records include, but are not limited to: books of account, invoices, sales receipts, *cash register tapes*, purchase orders, exemption certificates, returns, and schedules and working papers used in connection with the preparation of returns." [Emphasis added]

The Court stated that the fact that the regulation includes the words "cash register tapes" carries weight and that "this term is not superfluous nor can it be arbitrarily discarded."

However, statements in its decision raise the question of whether the Court understood how the Z Tape is created and what information is on it, namely that the Z tape is a summary of the same information contained on the cash register tapes.

In describing the taxpayer's bookkeeping operation, the Court stated that the taxpayer discarded the cash register tapes after the preparation of the Z tapes and that "the plaintiff took it upon himself to take information from the cash register tapes and record it onto its Z tapes as an alternative to keeping the cash register tapes…".

The Court noted that the auditor found "discrepancies that could only be resolved by examining the original transactions shown on the cash register tapes." The discrepancies claimed by the auditor, however, were not between the cash register tapes and the Z tapes, but rather between the Z tapes and the cash count at the end of the night. What the Court appears to have failed to grasp is that the cash register tapes with the transaction details are printed from the same register as the Z tapes and indeed match the Z tapes. Contrary to the Court's assertion that the tapes with the individual transactions did not match the Z tapes, it was the *cash deposits* that did not match the Z tapes. These discrepancies, which the Court noted "were of a minor nature," could be explained by either employee theft or employee mistakes in making change. The Court reasoned that because of the discrepancies, the Z tapes themselves were unreliable, and therefore the DRS had no choice but to use its own method for determining gross receipts. In fact, these discrepancies would have existed even if the taxpayer had the cash register tapes with the individual transactions listed.

The taxpayer argued that, when it maintained records in the normal course of business, the burden shifted to the Commissioner to show the records were substantially incorrect. The Court, however, concluded that the burden rested with the taxpayer to present clear and convincing[3] evidence that the Commissioner's assessment was incorrect. Here, because the taxpayer failed to maintain the cash register tapes with the individual transactions, the taxpayer failed to meet his burden of proof that the deficiency by the DRS was incorrect.

Though it is unclear at the time of this article if the Court's decision will be appealed by the taxpayer, practitioners need to be aware of the DRS position that Z tapes, despite being generated by the register, are not sufficient documentation to meet the recordkeeping requirements of the state regulations.

Jeopardy Assessments

Connecticut General Statutes § 12-417(1) provides:

[3] The Court's burden of proof standard for taxpayers has historically been "preponderance of the evidence" which was considered to be more than 50%. Then, in the Stew Leonard decision (264 Conn. 286, 823 A.2d 1184, (2003)) the court misstated the standard as "clear and convincing evidence", creating a much higher standard for taxpayers to show the DRS's assessment is incorrect. The Tax Session of the Connecticut Superior Court continues to use this standard, despite opposition raised by the Connecticut Bar Association.

> "**Jeopardy assessment. Notice**. If the commissioner believes that the collection of any tax or any amount of tax required to be collected and paid to the state or of any assessment will be jeopardized by delay, the commissioner shall make an assessment of the tax or amount of tax required to be collected, noting that fact upon the assessment and serving written notice thereof, personally or by mail, in the manner prescribed for service of notice of a deficiency assessment, on the person against whom the jeopardy assessment is made. Ten days after the date on which such notice is served on such person, such notice shall constitute a final assessment except only for such amounts as to which such person has filed a written petition for reassessment with the commissioner, as provided in subdivision (3) of this section."

Thus, the issuance of a jeopardy assessment reduces the window of time a taxpayer has to appeal from 60 days to 10 days, placing a significant burden on taxpayers and their representatives to quickly file an appeal to maintain their rights.

In its analysis, the Court stated that, although the Commissioner has the authority to issue jeopardy assessments, the analysis must include "whether there was a reasonable or rational basis for the commissioner to act against the plaintiff."

The taxpayer was in business for 14 years, owned multiple pieces of real estate and served on a number of community boards. The only apparent reason for the jeopardy assessment was the taxpayer's refusal to extend the statute of limitations.

Concluding there was no basis for the DRS auditor to believe the taxpayer was contemplating moving assets or fleeing the state, the Court determined the Commissioner's jeopardy assessment was without merit, and removed the fraud and attempt to evade penalty and the state marshal's fee from the determination.

Conclusion

The Court did not address the point that a Z tape is generated by the same register as a tape with all the individual transactions, and therefore should be considered a "cash register tape" within the meaning of the regulation. The regulation does not expressly state that the cash register tape must list all the individual transactions. Nevertheless, unless or until this decision is reversed or a new case decision is issued, practitioners need to be aware that clients in retail businesses must maintain the actual cash register tapes showing the individual transactions, as the DRS will not accept Z tapes or other forms of summary documents from taxpayers. Failure to maintain the register tapes showing the individual sales will leave the taxpayer susceptible to the DRS's determination that the taxpayer failed to provide adequate records, allowing the DRS to re-determine the taxpayer's receipts using its own method and ignore the taxpayer's actual documentation.

Practitioners must be alert to the issuance of a jeopardy assessment and its 10 day deadline to appeal, and be prepared to document facts challenging the use of the jeopardy assessment against the client. Representatives should ensure that the DRS presents sufficient evidence to support a conclusion that the taxpayer intends to leave the jurisdiction or shift assets out of the jurisdiction.

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