STATE OF MICHIGAN

COURT OF CLAIMS

EBI-DETROIT, INC v MICHIGAN DEP'T OF TREASURY

Case No. **16-000237-MT** Hon. Michael J. Talbot

ORDER

At a session of said Court held,
Detroit, Wayne County, Michigan, on
April 6, 2018.

Defendant having filed a motion for summary disposition pursuant to MCR 2.116(C)(10);

IT IS HEREBY ORDERED that defendant's motion is GRANTED with respect to the propriety of its use tax assessment.

IT IS FURTHER ORDERED that plaintiff is entitled to summary disposition pursuant to MCR 2.116(I)(2) with respect to defendant's imposition of an intentional disregard penalty.

This is a final order that resolves the last pending claim and closes the case.

Michael J. Talbot, Judge

A true copy entered and certified by Jerome W. Zimmer Jr., Clerk, on

April 6, 2018
Date

Clerk

STATE OF MICHIGAN

COURT OF CLAIMS

EBI-DETROIT, INC.,

Plaintiff,

v Case No. 16-000237-MT

MICHIGAN DEPARTMENT OF TREASURY, Hon. Michael J. Talbot

Defendant.

OPINION

Currently before the Court is defendant's motion for summary disposition under MCR 2.116(C)(10). The dispute in this case concerns an assessment under the Use Tax Act (UTA), MCL 205.91, *et seq.* For the reasons stated herein, defendant's motion is GRANTED with respect to the propriety of its use tax assessment, and plaintiff is entitled to partial summary disposition pursuant to MCR 2.116(I)(2) with respect to defendant's imposition of an intentional disregard penalty.

I. FACTUAL BACKGROUND

This matter arises from a use tax audit conducted by defendant for the period of April 1, 2009, through March 31, 2013 (tax years). Plaintiff is a general contractor that formerly engaged in new construction and remodeling projects. In the course of its business, plaintiff engaged subcontractors to provide materials and perform various work at plaintiff's projects. During the tax years at issue, plaintiff was in the process of winding down its business and did not register for or remit sales, use, or withholding tax. However, in its 2009 federal tax return, plaintiff reported cost of goods sold (COGS) in the amount of $4,010,072. Schedule A to the return

indicated that the COGS total included $17,851 in purchases and $3,992,221 in "other costs." A statement filed with the 2009 tax return divided plaintiff's "other costs" into four categories:

DESCRIPTION	AMOUNT
CONTRACTED SERVICES – LITIGATION SETTLEMENT	3,162,348.
GENERAL CONDITIONS COSTS	1,637.
MANAGEMENT AND ADMINISTRATIVE FEES	300,000.
SUBCONTRACTORS	528,236
TOTAL TO FORM 1120S, PAGE 2, LINE 5	3,992,221.

On January 22, 2015, defendant requested invoices, check copies, and payment details verifying that the sales tax had been paid, or was not due, on plaintiff's COGS expenditures. According to plaintiff's president, plaintiff was unable to produce complete records because many of them had been lost in the process of transferring the records between various offices for consultation purposes.[1] Plaintiff was able to produce limited subcontracts, a partial check register, a general ledger, and various bank statements. Plaintiff maintains that it also made certain job files related to projects that were performed or closed in 2009 or 2010 available for inspection.

Defendant performed an indirect audit, fully reviewing all records produced by plaintiff and employing a "subtraction method" to estimate plaintiff's use tax liability. For 2009, defendant began with the COGS amount reported on plaintiff's federal tax return and subtracted $1,679,637.62 attributable to expenditures for subcontractors that provided labor only or expenditures for which plaintiff could demonstrate that sales tax had been paid. Defendant also subtracted $1,246,140.68 in payments that were made outside of the audit period. Based upon

[1] According to plaintiff's CPA, some of plaintiff's records were located at his office, while other records were taken to plaintiff's attorney because plaintiff engaged in "unique litigation" during the tax years at issue.

these calculations, defendant found exceptions in the amount of $1,084,239.70 upon which use tax was due and owing. For 2010 through 2013, defendant reviewed plaintiff's bank statements to identify checks for expenditures that might be subject to use tax. Where plaintiff was unable to produce copies of checks with corresponding invoices showing that sales tax had been paid, defendant assessed use tax on the amount of the unsubstantiated payment. Treasury ultimately assessed $69,085 in use tax for the tax years at issue, a $17,273 penalty, and $4,243.35 in interest.

Plaintiff filed the instant action on September 26, 2016, challenging the audit methodology employed by defendant. According to plaintiff, defendant erred by concluding that plaintiff's records were insufficient and failed to comply with indirect audit method set forth in MCL 205.104a(4). In particular, plaintiff averred that defendant erroneously relied upon plaintiff's COGS expenses as the measure of plaintiff's taxable purchases, despite the fact that its review of relevant transaction records indicated a 0% error rate and complete compliance with the sales and use tax statutes.

Defendant moves for summary disposition pursuant to MCR 2.116(C)(10), arguing that plaintiff reported its purchase of building materials as COGS on its federal return and is therefore liable for use tax on any amount for which plaintiff is unable to establish entitlement to an exception. Defendant contends that its audit methodology was appropriate because it relied on the best available information to determine plaintiff's use tax liability. Defendant further argues that, because its assessment is prima facie correct under MCL 205.104a(4) and MCL 205.68(4), plaintiff has the burden of demonstrating otherwise and has failed to do so. Plaintiff, on the other hand, argues that defendant fails to recognize the distinction between the purchase of subcontracted services and the purchase of tangible property. Plaintiff explains that the majority

of its expenses involved payment for subcontracted services under contracts clearly specifying that the subcontractor is responsible for all associated taxes. According to plaintiff, even if its contracts had not placed tax liability on the subcontractors, it is a fundamental rule that the a subcontractor is responsible for taxes because the subcontractor is the party that actually consumes the building materials and supplies. Additionally, plaintiff maintains the COGS reported on its federal tax return was an improper starting point for defendant's calculations because the COGS figure consisted of approximately $3.16 million in settlement payments arising from contracted services performed in earlier years, $530,000 in payments to subcontractors, $300,000 in management and administrative fees, and only $20,000 in inventory and general condition costs that could potentially involve taxable purchases of tangible property. Lastly, plaintiff argues that defendant failed to demonstrate support for imposing a 25% penalty.

II. STANDARD OF REVIEW

"Summary disposition is appropriate under MCR 2.116(C)(10) if there is no genuine issue regarding any material fact and the moving party is entitled to judgment as a matter of law."[2] A court ruling on a motion under MCR 2.116(C)(10) must consider the "pleadings, affidavits, depositions, admissions, and other admissible evidence submitted by the parties in the light most favorable to the nonmoving party."[3] When the nonmoving party has the ultimate burden of proof at trial, the moving party can satisfy its burden of production under MCR 2.116(C)(10) by "submit[ting] affirmative evidence that negates an essential element of the nonmoving party's claim, *or* by demonstrat[ing] to the court that the nonmoving party's evidence

[2] *Dancey v Travelers Prop Cas Co of America*, 288 Mich App 1, 7; 792 NW2d 372 (2010) (quotation marks and citation omitted).

[3] *Robins v Garg (On Remand)*, 276 Mich App 351, 361; 741 NW2d 49 (2007).

is insufficient to establish an essential element of the nonmoving party's claim."[4] If the nonmoving party fails to produce evidence sufficient to demonstrate an essential element of its claim, the moving party is entitled to summary disposition.[5] On the other hand, "[i]f it appears to the court that the opposing party, rather than the moving party, is entitled to judgment, the court may render judgment in favor of the opposing party."[6]

III. ANALYSIS

A. PROPRIETY OF USE TAX ASSESSMENT

Resolution of the issues presented in this case requires application of the UTA. The UTA imposes a 6% tax "for the privilege of using, storing, or consuming tangible personal property in this state . . . ."[7] The UTA also provides various exemptions from use tax, including an exemption for "[p]roperty sold in this state on which transaction a tax is paid under the [General Sales Tax Act, MCL 205.51 *et seq*.,] if the tax was due and paid on the retail sale to a consumer."[8] However, "[t]he legal responsibility for use tax falls solely on the consumer," and a taxpayer seeking an exemption under MCL 205.94(1)(a) bears the burden of proving

[4] *Lowrey v LMPS & LMPJ, Inc*, 500 Mich 1, 7; 890 NW2d 344 (2016) (quotation marks and citation omitted; alterations in original).

[5] *Id*. at 9.

[6] MCR 2.116(I)(2).

[7] MCL 205.93(1).

[8] MCL 205.94(1)(a).

entitlement.[9] As such, use tax is properly assessed on in-state purchases when the taxpayer fails to demonstrate that sales tax was in fact paid at the time of the sale.[10]

The UTA also imposes recordkeeping requirements, including an obligation to maintain "certain records the department considers sufficient to show whether or not that person is liable for the tax under this act."[11] When a taxpayer fails to maintain sufficient records, defendant is authorized to assess use tax through alternative methods:

> If a taxpayer fails to file a return or to maintain or preserve sufficient records as prescribed in this section, or the department has reason to believe that any records maintained or returns filed are inaccurate or incomplete and that additional taxes are due, the department may assess the amount of the tax due from the taxpayer based on an indirect audit procedure or any other information that is available or that may become available to the department. That assessment is considered prima facie correct for the purpose of this act and the burden of proof of refuting the assessment is upon the taxpayer. An indirect audit of a taxpayer under this subsection shall be conducted in accordance with 1941 PA 122, MCL 205.1 to 205.31, and the standards published by the department under section 21 of 1941 PA 122, MCL 205.21, and shall include all of the following elements:
>
> (a) A review of the taxpayer's books and records. The department may use an indirect method to test the accuracy of the taxpayer's books and records.
>
> (b) Both the credibility of the evidence and the reasonableness of the conclusion shall be evaluated before any determination of tax liability is made.
>
> (c) The department may use any method to reconstruct income, deductions, or expenses that is reasonable under the circumstances. The department may use third-party records in the reconstruction.[12]

---

[9] *Andrie, Inc v Treasury Dep't*, 496 Mich 161, 165, 169; 853 NW2d 310 (2014).

[10] *Id*. at 170.

[11] MCL 205.104a(2). As used in MCL 205.104a, " 'Sufficient records' means records that meet the department's need to determine the tax due under this act." MCL 205.104a(7)(b).

[12] MCL 205.104a(4).

Here, plaintiff argues that defendant's audit method was improper because it failed to account for the fact that the COGS reported on plaintiff's 2009 federal return was largely attributable to expenditures that are not taxable under the UTA, namely, litigation expenses, payments for subcontracted services, and management and administrative expenses. However, while plaintiff's CPA, David Croskey, testified that the overwhelming majority of plaintiff's reported COGS for 2009 included litigation settlement payments, plaintiff failed to provide any documentation substantiating this assertion. According to Croskey, the best way to verify the nature of these payments was to work off of plaintiff's trial balance and compare journal entries and source documents like contracts and court settlement papers. Yet plaintiff failed to present any such documentation to this Court. Instead, plaintiff simply asserts that it made extensive records related to its litigation settlement available to defendant. As such, plaintiff's arguments are unpersuasive because "[a] litigant's mere pledge to establish an issue of fact at trial cannot survive summary disposition under MCR 2.116(C)(10)."[13]

Plaintiff next points to its standard practice of specifying that taxes are included in the price of quotes, purchase orders, and subcontractor agreements. But the only documents presented to this Court pertaining to agreements between plaintiff and its subcontractors refer to two subcontractors who provided work on different projects, both of which appear to have been completed before the beginning of the tax years under review in the audit. Thus, these documents do little to show the terms of the agreements between plaintiff and its subcontractors during the tax years. In other words, plaintiff essentially asks this Court to presume that it paid

[13] *Maiden v Rozwood*, 461 Mich 109, 121; 597 NW2d 817 (1999).

sales tax on every expenditure made to a subcontractor—a proposition that was directly rejected by the Supreme Court in *Andrie*, wherein the Court explained,

> The exemption statute unambiguously requires payment of the sales tax before it exempts the taxpayer from the use tax. It is not enough that the sales tax was due on the retail sale of the property; rather, sales tax must be both "due *and* paid" before the exemption applies. Thus, the department properly assessed use tax on in-state purchases where [the plaintiff] failed to submit evidence that sales tax was actually paid at the time of sale.[14]

Plaintiff's attempt to distinguish *Andrie* on the basis of the type of purchase lacks merit. Although it is true that tangible personal property like the fuel and supplies at issue in *Andrie* are generally subject to use tax, while sales of services are generally outside the scope of the UTA,[15] this distinction is not borne out by the evidence presented to this Court. That is, plaintiff has failed to present any documents showing that the expenditures upon which defendant assessed use tax were for subcontracted services, rather than tangible personal property.

Plaintiff reliance on Revenue Admin Bull 2016-18, which provides that a general contractor is not liable for sales or use tax on materials consumed by an independent subcontractor, is misplaced for the same reason Although revenue bulletins do not constitute authoritative law,[16] courts give an agency's interpretation of relevant statutes respectful consideration.[17] But assuming, without deciding, that Revenue Admin Bull 2016-18 is

---

[14] *Andrie*, 496 Mich at 170. The Court further explained that "[a] presumption of sales tax payment would shift this burden to the department, contrary to established law regarding tax exemptions." *Id*. at 171-172.

[15] *Catalina Marketing Sales Corp v Dep't of Treasury*, 470 Mich 13, 19; 678 NW2d 619 (2004).

[16] *Id*. at 21.

[17] *Clam Lake Twp v Dep't of Licensing & Regulatory Affairs*, 500 Mich 362, 372; 902 NW2d 293 (2017).

consistent with the plain language of the UTA, plaintiff's argument still ignores the central issue—i.e., lack of substantiating documentation showing that plaintiff's COGS expenditures were for services. Accordingly, plaintiff has failed to rebut the statutory presumption that defendant's assessment was prima facie correct.

B. INTENTIONAL DISREGARD PENALTY

Lastly, this Court must determine whether defendant properly imposed a 25% penalty to the use tax assessment. If defendant determines that a taxpayer has not satisfied its tax liability, the taxpayer is subject to interest and penalties.[18] MCL 205.23 sets forth different types of penalties, including a negligence penalty and an intentional disregard penalty. If any part of a tax deficiency is due to the taxpayer's negligence, defendant may impose a penalty of $10 or 10% of the tax deficiency, whichever is greater.[19] If any part of the tax deficiency is due to the taxpayer's "intentional disregard of the law or of the rules promulgated by the department," the penalty is increased to the greater of $25 or 25% of the deficiency.[20]

Here, defendant imposed an intentional disregard penalty based upon plaintiff's involvement in a similar audit in 2008. According to defendant, the sufficiency of plaintiff's recordkeeping was at issue in the earlier audit, thereby placing plaintiff on notice that it needed to make changes to its internal controls and document retention policies. Despite this understanding, plaintiff's president testified in this case that he verbally instructed staff "to be more aware and to double-check things," but did not take any other corrective action after the

[18] MCL 205.23(1).

[19] MCL 205.23(3).

[20] MCL 205.23(4).

2008 audit. Defendant argues that because plaintiff was aware from the earlier audit that it must maintain sufficient documentation to support its claimed exemptions, its continued poor recordkeeping amounted to intentional disregard of the law. This Court disagrees.

Plaintiff appealed defendant's 2008 audit to the Michigan Tax Tribunal. Like the instant case, defendant's use tax assessment was based largely on plaintiff's failure to provide invoices or records reflecting the payment of sales tax for certain purchases.[21] In its final opinion and judgment, the tribunal recognized that plaintiff was only able to produce partial records because other records had purportedly been lost. Nonetheless, the tribunal determined that use tax was improperly assessed for the majority of the subject purchases based upon the limited evidence presented, including letters from vendors stating that tax was collected on transactions and select purchase orders with plaintiff's standard "sales tax included" language.[22] Additionally, the auditor responsible for the assessment was not available to "defend the completeness and accuracy of his or her findings."

Although it appears that plaintiff's poor recordkeeping caused the auditor to determine that plaintiff was liable for additional use tax, the records plaintiff later produced were deemed sufficient to rebut the prima facie correctness of defendant's audit.[23] As such, plaintiff could have reasonably believed that its record keeping policies were sufficient in light of its successful challenge of the audit findings. Moreover, Mich Admin Code, R 205.1012(3) sets for several

[21] *EBI-Detroit, Inc v Mich Dep't of Treasury*, unpublished opinion of the Michigan Tax Tribunal, issued November 16, 2011 (Docket No. 382224).

[22] Unlike in this case, the sample purchase orders plaintiff submitted to the tribunal were for transactions that took place during the relevant audit period.

[23] *Id*.

examples of circumstances in which the tax deficiency is deemed to result from the taxpayer's negligence, including the following:

> The taxpayer has been assessed a deficiency. There is a subsequent audit of the taxpayer that results in a similar deficiency for a subsequent tax period resulting from the taxpayer's failure to correct internal controls and reporting procedures that contributed to the original assessment.

The Court finds the circumstances in the instant case sufficiently analogous to this example, such that plaintiff's failure to retain sufficient records relating to the tax years at issue should be considered negligent at most. Accordingly, defendant erred by assessing an intentional disregard penalty against plaintiff under MCL 205.23(4). Furthermore, MCL 205.23(4) provides that defendant may not impose a negligence penalty against a taxpayer when an intentional disregard penalty is successfully disputed. Therefore, defendant may not impose any penalty against plaintiff with respect to its tax deficiency in this case.

IV. CONCLUSION

For the reasons stated herein, defendant's motion is GRANTED with respect to the propriety of its use tax assessment, and plaintiff is entitled to partial summary disposition pursuant to MCR 2.116(I)(2) with respect to defendant's imposition of an intentional disregard penalty.

Dated: April 6, 2018

Michael J. Talbot, Judge