RECORDS, ESTIMATES, AND SAMPLING, OH MY! UNDERSTANDING THE LIMITS OF STATUTORY AUTHORITY FOR FLORIDA TAX AUDIT ESTIMATES AND SAMPLING

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A tax audit conducted by the Florida Department of Revenue can be a harrowing experience. Even when the taxpayer has done everything right, it is never comfortable having an auditor comb through years of records looking for things that might have gone wrong. Two aspects of the department's audit authority are not generally well understood by taxpayers, and if they are neglected, they can lead to very unexpected results. These are the department's statutory authority to *estimate* a taxpayer's liability and the authority to *sample* a taxpayer's records during the audit.

Why Does This Matter?

Unless you practice in this area, you may be wondering, "Why would anyone care about estimates or sampling?" If the department conducts an estimate, then the taxpayer is not being assessed based on its actual business operations. Instead, the taxpayer is being assessed tax, penalty, and interest based on an auditor's *best guess* about what the taxpayer's liability *might be*. This can be catastrophic in some cases, as six-figure (and higher) liabilities can be created out of thin air.

This is not to say the department is wrong to conduct estimates. To the contrary, if a taxpayer is wrongfully denying the department access to its records, the department has clear statutory authority to protect the state's revenue by assessing the taxpayer through an estimate process. However, care must be taken that this power to estimate is only exercised within the bounds of the department's statutory authority. A taxpayer that produces its records should be audited on what those records show. The taxpayer should not be assessed based on a "guesstimate" that is untethered from reality.[1]

As for sampling, it is often in the taxpayer's interest to have its records sampled during an audit. This is especially true with high-volume retail businesses, where examining each receipt would cause an audit to take far longer than anyone would want. However, the parameters of the estimate are important to get right. Should a seasonal business be audited based on its highest-volume months, with the result extrapolated across a

three-year audit period? Certainly not. Should a business with a large error that occurred once have that error included in the sample and applied to the entire audit period? Again, certainly not.

How the taxpayer and its counsel handle these issues can turn the tide of an audit. This article attempts to clearly state the limits of the department's statutory power to issue an assessment based on an estimate or a sampling of the taxpayer's records. This article addresses the department's authority to audit and the taxpayer's duty to keep records, as both issues impact the estimate and sampling process.

The Department's Audit Authority

To begin, we must establish what it means for the department to conduct an audit. The source of the department's audit authority is F.S. §213.34, which provides:

> *The Department of Revenue shall have the authority to audit and examine the accounts, books, or records of all persons who are subject to a revenue law made applicable to this chapter, or otherwise placed under the control and administration of the department, for the purpose of ascertaining the correctness of any return which has been filed or payment which has been made, or for the purpose of making a return where none has been made.*[2]

This provision grants the department broad authority to audit both taxpayers that have filed a return, as well as persons or entities who have not filed a return when one was due.[3] At its most basic level, an audit consists of the department's examination of the taxpayer's records to determine whether the taxpayer has complied with Florida's tax laws. The department has statutory authority to review taxpayer records in this manner pursuant to §213.34(2). This section provides that "[t]he department, or its duly authorized agents, may inspect such books and records necessary to ascertain a taxpayer's compliance with the revenue laws of this state, provided that the department's power to make an assessment or grant a refund has not terminated under s. 95.091(3) [the statute of limitations]."[4]

The key provision in this section is that the department's audit focuses on the taxpayer's *records*. The question of whether the department has the legal authority to conduct an estimate or to engage in a sampling process centers on the type and extent of the records kept by the taxpayer. With that in mind, we will now examine the taxpayer's record-keeping obligations.

Taxpayer's Duty to Keep Records

While the department has the authority to audit a taxpayer's books and records, the taxpayer has a corresponding duty to keep such records and to make them available for examination. This duty is imposed on the taxpayer under F.S. §213.35. This section provides:

> *Each person required by law to perform any act in the administration of any tax enumerated in s. 72.011 shall keep suitable books and records relating to that tax, such as invoices, bills of lading, and other pertinent records and papers, and shall preserve such books and records until expiration of the time within which the department may make an assessment with respect to that tax pursuant to s. 95.091(3) [the statute of limitations].*[5]

Under this statute, taxpayers are expected to maintain "suitable" books and records that support their tax filings for the applicable statute of limitations period. Because the normal limitations period is three years, the statute effectively requires three years of suitable records for the department to audit.[6]

The department has elaborated on the taxpayer's duty to maintain records through administrative regulations. The operative regulations are found at Florida Administrative Code Rule 12-3.0012 and Rules 12-24.021 through 12-24.029.[7] Rule 12-3.0012 contains general definitions for several terms, two of which are relevant to taxpayer records. These two terms are "adequate records" and "voluminous records." Both defined terms are implicated in the department's statutory authority to perform an estimate or to engage in a sampling procedure.

The term "adequate records" is defined to mean "books, accounts, and other *records sufficient to permit a reliable determination of a tax deficiency or overpayment*."[8] To be "sufficient to make a reliable determination" of a deficiency or overpayment, the records must be:

> *1. Accurate, that is, the records must be free from material error; 2. Inclusive, that is, the records must capture transactions that are needed to determine a tax deficiency or overpayment; 3. Authentic, that is, the records must be worthy of acceptance as based on fact; and 4. Systematic, that is, the records must organize transactions in an orderly manner.*[9]

This definition of adequate records is best understood as a directional rule to be applied to the facts of each individual taxpayer. The qualitative nature of the standard, which turns on a determination of materiality, worthiness of acceptance, and relative

orderliness, means that reasonable minds could differ on whether a given taxpayer's records are "adequate" under the rule. The adequacy of records is implicated in both the department's power to perform an estimate and to engage in a sampling procedure.[10]

The term "voluminous records" is defined to mean "records maintained by the taxpayer that are so numerous and extensive that their provision by the taxpayer and review by the Department would not be practical under the circumstances of the time, space, and other logistical constraints of the taxpayer and the Department."[11] The question of whether records are "voluminous" is implicated in whether the department has the authority to conduct an audit through sampling procedures.[12]

Hard Copy or Electronic Records?

Rules 12-24.022 through 12-24.029 generally address electronic recordkeeping requirements and procedures. However, it is important to note that taxpayers *are not required* to maintain their records in an electronic format.[13] The regulations explicitly provide that

> *[n]othing in this [p]art [of the regulations addressing recordkeeping] shall be construed to prohibit a taxpayer from demonstrating tax compliance with traditional hardcopy documents or reproductions thereof, in whole or in part, whether or not such taxpayer also has retained or has the capability to retain records on electronic or other storage media in accordance with this [p]art.[14]*

Therefore, a taxpayer that has kept physical records of its business operations has the right to prove its compliance with the state's tax laws with those records, as long as the records are adequate under the rules.[15] However, when a taxpayer has kept the same information in both hardcopy and in electronic "machine-sensible" form, the taxpayer must make the electronic records available for audit.[16]

It must also be noted that the taxpayer has no obligation to create electronic or machine-sensible records when they do not already exist. To that end, the rules state that "[t]axpayers are not required to construct machine-sensible records other than those created in the ordinary course of business. A taxpayer who does not create the electronic equivalent of a traditional paper document in the ordinary course of business is not required to construct such a record for tax purposes."[17] This provision is important to keep in mind, as the author has seen auditors request this of taxpayers. When records only exist in hard copy, the taxpayer is *not* required to transform them into electronic documents for the department.[18]

The issue of electronic records has become especially important in recent years, as there has been a noticeable trend in which some auditors may discount physical records and over-emphasize records that are electronically available. For many small businesses, a “mixed” method of recordkeeping is quite common. This can lead to an auditor not wanting to review hardcopy records that are not easily exportable into a spreadsheet. While that impulse is understandable at the human level, the attorney must insist that a taxpayer who has kept adequate physical records be audited on those records, provided that the same information is not also available electronically.

“Estimates” and the Department’s Authority

An “estimate” of a taxpayer’s liability occurs when the department uses information outside of the taxpayer’s business records to determine how much tax, penalty, and interest to impose in an assessment. The authority for such estimates is derived from F.S. §212.12(5)(b), which reads:

> *In the event any dealer or other person charged herein fails or refuses to make his or her records available for inspection so that no audit or examination has been made of the books and records of such dealer or person, fails or refuses to register as a dealer, fails to make a report and pay the tax as provided by this chapter, makes a grossly incorrect report or makes a report that is false or fraudulent, then, in such event, it shall be the duty of the department to make an assessment from an estimate based upon the best information then available to it for the taxable period of retail sales of such dealer, the gross proceeds from rentals, the total admissions received, amounts received from leases of tangible personal property by such dealer, or of the cost price of all articles of tangible personal property imported by the dealer for use or consumption or distribution or storage to be used or consumed in this state, or of the sales or cost price of all services the sale or use of which is taxable under this chapter, together with interest, plus penalty, if such have accrued, as the case may be. Then the department shall proceed to collect such taxes, interest, and penalty on the basis of such assessment which shall be considered prima facie correct, and the burden to show the contrary shall rest upon the dealer, seller, owner, or lessor, as the case may be.*[19]

This statute specifically links the department’s ability to perform an estimate to the taxpayer’s refusal to cooperate in the audit process. The taxpayer must fail to provide its records for inspection, fail to file a return when required, or otherwise participate in one of the listed statutory transgressions before the department can estimate liability.[20]

On this point, the Fifth District Court of Appeal has held that:

> *Section 212.12(5)(b) allows the Department to assess by guesstimates based upon selected available data, and then be afforded the presumption of correctness. These are rather Draconian provisions, to say the least. It seems clear from the language of section 212.12(5)(b) that its best estimate provisions should not come into operation unless the dealer or person to be charged has done something wrong or obstructive to prevent the Department from making a fair or ordinary audit.*[21]

Decisions of administrative law judges have been to the same effect.[22] Because the taxpayer must do something "wrong or obstructive" with records or returns in order to allow the department to perform an estimate, it is critical that the taxpayer document his or her efforts to make records available for audit. It is strongly advised that the taxpayer insist that document requests from the department be made in writing, and that the taxpayer respond to such requests in writing with an explanation of what is being produced and why. Paper trails are critical in proving the taxpayer's lack of wrongdoing after the fact. This can be dispositive in contesting an estimate in protest or later litigation.

"Sampling" and Taxpayer Records

The department has the statutory authority to sample a taxpayer's records in two circumstances: 1) when the taxpayer's records are *inadequate*; and 2) when the taxpayer's records are *adequate but voluminous*.[23] Unless one of these statutory predicates are satisfied, the department cannot assess tax (or issue a refund) based on a sampling procedure.

As to the first circumstance, §212.12(6)(b) provides, in pertinent part, that:

> *if a dealer does not have adequate records of his or her retail sales or purchases, the department may, upon the basis of a test or sampling of the dealer's available records or other information relating to the sales or purchases made by such dealer for a representative period, determine the proportion that taxable retail sales bear to total retail sales or the proportion that taxable purchases bear to total purchases.*[24]

The adequacy of a taxpayer's records is determined, as set forth above, by the subjective test provided by the regulations. It is important to note that the lack of adequate records has nothing to do with malfeasance on the part of the taxpayer. This is in contrast to the department's estimate authority, where the taxpayer must essentially be a bad actor in

order for an estimate to be conducted. Instead, the sampling authority under subsection (6)(b) addresses taxpayers that do not have records that are complete enough to allow a comprehensive audit of every transaction in the audit period.

Records can be inadequate for a host of reasons, including the fact that significant amounts of records have been wiped out by natural disasters in which taxpayers did not have hurricane-proof backup systems. In such cases, a sampling may be an entirely acceptable way to efficiently conduct an audit where records are incomplete.

As to the second circumstance where sampling is available, §212.12(6)(c) provides that:

> *if the records of a dealer are adequate but voluminous in nature and substance, the department may sample such records and project the audit findings derived therefrom over the entire audit period to determine the proportion that taxable retail sales bear to total retail sales or the proportion that taxable purchases bear to total purchases. In order to conduct such a sample, the department must first make a good faith effort to reach an agreement with the dealer, which agreement provides for the means and methods to be used in the sampling process. In the event that no agreement is reached, the dealer is entitled to a review by the executive director.*[25]

This provision normally comes into play when a taxpayer has a high volume of retail sales and neither the taxpayer nor the auditor wants to look at every single transaction for the entire three-year audit period. In such cases, the department is required to work with the taxpayer to agree on the means and methods of the sample to use. These "means and methods" normally involve the time period the sample will cover and what records will be the subject of the sample.[26]

The key to subsection (6)(c) is that the department must seek an *agreement* with the taxpayer on how the sample is to be conducted. The statute does not allow the auditor to impose a sample on the taxpayer without at least attempting to find common ground. The practitioner must be armed with this statute and ready to advocate for the taxpayer if this procedure is not honored.[27]

When negotiating over what sampling period and method to use, the practitioner must be attentive to seasonal changes in the taxpayer's business. Errors that may have occurred only during "peak" season when staff is overburdened may not be representative of the taxpayer's operations during non-peak times. If the sample only takes into account peak months, the results will necessarily be skewed.

Another issue to be attentive to is any known problems that the taxpayer might have. A common issue arises when a taxpayer purchases a large amount of equipment for use in the business but does not remit use tax to its vendor or to the state. This is common, as many business owners have been trained by the internet that online sales are tax-free. Though this issue will result in a use tax assessment, there is no reason to include that one big problem in an estimate that will average the liability over the course of the audit period. A better approach is to separately handle any known problems and to omit them from the larger sample. If taxpayers are candid with their attorneys, then these issues can often be resolved up-front before the estimate process has begun.

With any sample, it is important for the practitioner to know how the taxpayer's business works and what type of sample might be most appropriate for the situation. With proper communication, a sampling procedure can be used to the benefit of both the taxpayer and the state.

Conclusion

In an audit, the battle of the records means everything. Though the taxpayer must adhere to its record-keeping obligations, the department must also adhere to the statutory limitations on its ability to assess tax based on an estimate or sample. Practitioners must keep this in mind when defending an audit.

[1] The term "guesstimate" comes from the case of *Lloyd Enterprises, Inc. v. Department of Revenue*, 651 So. 2d 735, 739 (Fla. 5th DCA 1995), discussed later in this article. The author has seen estimates that do a very good job approximating what might have happened in the absence of records. The author has also seen estimates that are wildly untethered from anything approaching the taxpayer's business reality.

[2] Fla. Stat. §213.34(1).

[3] *Id*. For ease of reference, the person or entity under audit in this article is referred to as the "taxpayer."

[4] *Id*. The reference to Fla. Stat. §95.091(3) points to the statute of limitations applicable to the assessment and refund of Florida taxes. A three-year limitations period applies in most situations. This limitations period can be tolled for up to one year if the department commences the audit within the required period. There are some ambiguities in the

tolling process, however, that the author has explored in greater depth elsewhere. *See* Steven M. Hogan, *Tolling Statutes of Limitations in Florida Sales and Use Tax Audits*, 85 State Tax Notes 89 (Jul. 3, 2017).

[5] Fla. Stat. §213.35. The reference to Fla. Stat. §72.011 effectively applies this record-keeping duty to taxpayers that interact with any tax administered by the department.

[6] *See* note 4.

[7] *See* F.A.C.R. 12-24.021 ("Rules 12-3.0012 and 12-24.021 through 12-24.030, F.A.C., define the requirements imposed on taxpayers for the maintenance and retention of books, records, and other sources of information under Section 213.35, F.S. These rules address such requirements where all or a part of the taxpayer's records are received, created, maintained or generated through computer, electronic, and imaging processes and systems. Unless in conflict with the specific requirements imposed by other rules of the Department, these rules shall govern the recordkeeping and retention requirements imposed by the revenue laws administered by the Department." Though Rule 12-24.030 has been repealed, the text of Rule 12-24.021 remains unchanged.).

[8] F.A.C.R. 12-3.0012(3) (emphasis added).

[9] F.A.C.R. 12-3.0012(3)(a).

[10] The rule elaborates further on the determination process in subsection (b), which states: "The nature of the taxpayer's business, the nature of the industry, materiality, third-party confirmations and other corroborating evidence such as related supporting documentation, and the audit methods that are suitable for use in the audit, will be used to establish that the taxpayer has adequate records." Fla. Admin. Code R. 12-3.0012(3)(b). The rule creates a "totality of the circumstances" test that can potentially implicate third-party corroborating data. If this becomes an issue, the attorney must insist that the department disclose what third-party data it is relying on so that the taxpayer can effectively defend the propriety of its records.

[11] F.A.C.R. 12-3.0012(4).

[12] Though this is not normally a controversial question in an audit, there may be times when a taxpayer and the auditor disagree on whether records are voluminous enough to warrant a sample.

[13] In our era of ubiquitous computers and database software, it is almost a given that most of us think of records as something that exists, one way or another, in electronic form. At times, the electronic version of a record can seem more *real* than a physical copy, as the electronic version can be duplicated endlessly so long as the printer has enough paper. Despite this modern bias that many of us share, there is no requirement that any taxpayer maintain its records in electronic form.

[14] F.A.C.R. 12-24.023(3) (emphasis added).

[15] *Id*.

[16] F.A.C.R. 12-24.023(2). This rule section reads: "If a taxpayer maintains records required to be retained under this chapter in both machine-sensible and hardcopy formats, the taxpayer shall make the records available to the Department in machine-sensible format upon request of the Department."

[17] F.A.C.R. 12-24.024(1)(c).

[18] Though it must be said that there are times when creating digital versions of hardcopy documents is advisable. Sometimes scanning documents into. pdf form can make audits easier to conduct and can minimize the burden on the taxpayer. With that said, the department cannot insist on this and the taxpayer's counsel must be prepared to push back on unreasonable requests.

[19] Fla. Stat. §212.12(5)(b) (emphasis added). Though it is beyond the scope of this article to address what the term "prima facie correct" means in the case of estimates, it is worth noting that this may simply create a "bursting bubble" evidentiary presumption that vanishes once the taxpayer supplies rebuttal evidence. The author has made the case elsewhere that this is true for the "prima facie correct" evidentiary presumption the Department receives for personal liability assessments. *See* Steven M. Hogan, *Bursting Bubbles: Evidentiary Presumptions in Personal Liability Assessments*, 92 Fla. B. J. 4, 56 (Apr. 2018).

[20] A recent trend has found the department searching property records for business entities that occupy real property owned by a different entity or person, and performing an estimate of commercial rental tax due based on market rates. The specific authority for this is found in the statute's mention of the failure of a taxpayer to file a return when required (in such cases, a return remitting commercial rental tax). However, it is not always the case that a business occupying real property that is owned by another is

actually paying taxable rent. The details matter and can be contested by taxpayers with competent counsel. *See* Steven M. Hogan, *Taxation of Related-Party Commercial Leases in Florida*, 85 State Tax Notes 601 (Aug. 7, 2017).

[21] *Lloyd Enterprises, Inc. v. Department of Revenue*, 651 So. 2d 735, 739 (Fla. 5th DCA 1995) (emphasis added) (reversing sales tax assessment based on an estimate where taxpayer did not refuse to make his records available for inspection).

[22] *See, e.g.*, *American Import Car Sales, Inc. v. Department of Revenue*, DOAH Case No. 14-3115 (Recommended Order April 17, 2015) (estimate improper under §212.12(5)(b) because the taxpayer produced records for inspection); *Dunhill International List Co., Inc. v. Department of Revenue*, DOAH Case No. 02-3614 (Recommended Order May 27, 2003; Final Order Oct. 28, 2003) (same).

[23] Fla. Stat. §212.12(6)(b)-(c).

[24] *Id*. (emphasis added).

[25] Fla. Stat. §212.12(6)(c)1 (emphasis added).

[26] The department has sampling literature available to the public that explains its methods in technical detail, though one must be somewhat persistent to obtain it. *See* F.A.C.R. 12-3.0017 ("Adoption of Materials That Contain Departmental Procedures").

[27] Sometimes an auditor that is hard-pressed for time due to internal deadlines may try to force this issue. Though this is understandable at a human level, the practitioner must insist on adherence to the statutory procedure.

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