STATEOFCALIFORNIA

STATE BOARD OF EQUALIZATION
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June 27, 2008

Dear Interested Party:

Enclosed are the Agenda, Issue Paper, and Revenue Estimate for the July 8, 2008, Business Taxes Committee meeting. This meeting will address the proposed amendments to Regulation 1602.5, *Reporting Methods for Grocers*.

Action 1 on the Agenda concerns revising Regulation 1602.5 to delete language that requires or urges grocers to get Board approval before using an electronic scanning method, modified purchase ratio or cost plus mark-up methods to report the tax.

If you are interested in other topics to be considered by the Business Taxes Committee, you may refer to the "Business Taxes Committee" page on the Board's Internet web site (http://www.boe.ca.gov/meetings/btcommittee.htm) for copies of Committee discussion or issue papers, minutes, a procedures manual, and a materials preparation and review schedule arranged according to subject matter and meeting date.

Thank you for your input on these issues and I look forward to seeing you at the Business Taxes Committee meeting at **9:30 a.m.** on **July 8, 2008** in Room 121 at the address shown above.

Sincerely,

Randie L. Henry, Deputy Director
Sales and Use Tax Department

RLH: caw

Enclosures

cc: (all with enclosures)
Honorable Judy Chu, Ph.D., Chair, Fourth District
Honorable Betty T. Yee, Vice Chairwoman, First District (MIC 71)
Honorable Bill Leonard, Member, Second District (MIC 78)
Honorable Michelle Steel, Member, Third District
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel (via e-mail)
Mr. Mark Ibele, Board Member's Office, Fourth District (via e-mail)
Mr. Steve Shea, Board Member's Office, Fourth District (via e-mail)
Mr. Alan LoFaso, Board Member's Office, First District (via e-mail)
Ms. Sabina Crocette, Board Member's Office, First District (via e-mail)
Mr. Gary Qualset, Board Member's Office, First District (via e-mail)
Ms. Mengjun He, Board Member's Office, First District (via e-mail)
Mr. Lee Williams, Board Member's Office, Second District (via e-mail)
Mr. Erik Caldwell, Board Member's Office, Third District (via e-mail)
Mr. Ken Maddox, Board Member's Office, Third District (via e-mail)
Mr. Neil Shah, Board Member's Office, Third District (via e-mail)
Ms. Elizabeth Maeng, Board Member's Office, Third District (via e-mail)
Ms. Christina Rueck, Board Member's Office, Third District (MIC 77)
Ms. Melanie Darling, State Controller's Office (via e-mail)
Mr. Ramon J. Hirsig (via e-mail)
Ms. Kristine Cazadd (via e-mail)
Ms. Randie L. Henry (via e-mail)
Mr. Jeff Vest (via e-mail)
Mr. Robert Lambert (via e-mail)
Mr. Randy Ferris (via e-mail)
Mr. David Levine (via e-mail)
Ms. Windie Scott (via e-mail)
Mr. Cary Huxsoll (via e-mail)
Ms. Carla Caruso (via e-mail)
Mr. Todd Gilman (via e-mail)
Mr. Dave Hayes (via e-mail)
Ms. Laureen Simpson (via e-mail)
Ms. Freda Orendt (via e-mail)
Mr. Stephen Rudd (via e-mail)
Mr. Robert Buntjer (via e-mail)
Mr. Jeff McGuire (via e-mail)
Mr. James Kuhl (via e-mail)
Mr. Geoffrey E. Lyle (via e-mail)
Ms. Leila Hellmuth (via e-mail)
Ms. Cecilia Watkins (via e-mail)
Ms. Lynn Whitaker (via e-mail)

AGENDA — July 8, 2008 Business Taxes Committee Meeting
Proposed Revisions to Regulation 1602.5, *Reporting Methods for Grocers*

Action 1 — Regulation 1602.5 - *Reporting Methods for Grocers,* Deletion of Obsolete Language Issue Paper Alternative 1 – Consent Item Agenda Page 2	**Approve and authorize to publish the proposed revisions** as agreed upon by staff and industry representatives. The amendments would • Eliminate the requirement to obtain Board approval before using an electronic scanning method to report the tax, and • Delete the language urging grocers to seek Board approval prior to using the modified purchase ratio and the cost plus markup methods of reporting the tax. OR
Issue Paper Alternative 2	**Do not revise the** Regulation 1602.5

Action Item	Staff and Industry's Proposed Regulatory Language
Action 1 — Consent **Deletion of Obsolete Language**	**Regulation 1602.5. Reporting Methods for Grocers.** … **(b) REPORTING METHODS.** … (2) MODIFIED PURCHASE-RATIO METHOD. Any grocer who does not follow the procedure outlined in (b)(1), above, but reports on a purchase-ratio basis of some type is using a modified version of the purchase-ratio method. For example, grocers who include self-performed processing, manufacturing, warehousing or transportation costs in the purchase-ratio formula are using a modified version. Grocers using such a modified version must establish that their modified version does not result in an overstatement of their food products exemption. They may demonstrate the adequacy of their modified method by extending taxable purchases, adjusted for inventories, to retail for a representative period or computing taxable sales by marking up taxable purchases, adjusted for inventories, for a representative period. Grocers must retain adequate records which may be verified by audit, documenting the modified purchase-ratio method used. ~~Grocers contemplating use of a modified purchase-ratio reporting method are urged to notify the board of such intentions and to submit such methods to the nearest board office for review prior to use of such methods. Grocers submitting proposed modified purchase-ratio reporting methods meeting board approval will be furnished written notice indicating the period within which such modified methods are authorized for use.~~ (3) RETAIL INVENTORY METHOD AND MARKUP METHOD. Grocers who engage in manufacturing, processing, warehousing or transporting their own products may prefer to use a retail or markup method of reporting. These methods are described below: … **(B) Cost Plus Markup Method — Taxable Merchandise.** … 2. If the grocer elects to use the cost plus markup method of reporting, the following criteria should be followed: … ~~**G.** Grocers contemplating use of the cost plus markup method of reporting are urged to notify the board of such intentions and to submit a general outline of proposed markup procedures to the nearest board office for review prior to use of such procedures. Grocers submitting proposed markup procedures meeting board approval will be furnished written notice indicating the period within which such procedures are authorized for use.~~ (4) ELECTRONIC SCANNING SYSTEMS. The use of a scanning system is another acceptable reporting method for grocers. Electronic scanning systems utilize electronic scanners and central computers to automatically compile and record taxable and nontaxable sales, sales tax, and related data from scanning of products imprinted with the Universal Product Code. It is the grocer's responsibility to establish the propriety of reported amounts. Grocers must ensure that proper controls are maintained for monitoring and verifying the accuracy of the scanning results and tax returns. Adequate documentation must be retained which may be verified by audit, including all scanning programs relating to product identity, price, sales tax code, program changes and corrections to the programs. Records which clearly show a segregation of taxable and nontaxable merchandise purchases would provide an additional source from which the scanning accuracy may be monitored or verified. ~~Grocers contemplating use of electronic scanning systems results as a reporting method are required to notify the board of such intentions and to submit a general outline of the proposed procedures to the board for review and approval prior to adoption of such method for reporting purposes. Grocers submitting proposed scanning system procedures meeting board approval will be furnished written notice indicating the period within which such procedures are authorized for use.~~

Issue Paper Number **08-006**

☐ Board Meeting
☒ Business Taxes Committee
☐ Customer Services and Administrative Efficiency Committee
☐ Legislative Committee
☐ Property Tax Committee
☐ Other

BOARD OF EQUALIZATION
KEY AGENCY ISSUE

Proposed revisions to Regulation 1602.5, *Reporting Methods for Grocers*, Regarding the Use of the Electronic Scanning Systems

I. Issue

Whether to eliminate from the regulation the requirements that a grocer notify the Board and obtain Board approval before using an electronic scanning system for tax reporting purposes.

II. Alternative 1 - Staff Recommendation

As agreed upon by staff and industry representatives, staff recommends that the Board authorize publication of the proposed amendments to Regulation 1602.5 as illustrated in Exhibit 2. Staff recommends eliminating the requirement that grocers get Board approval before using an electronic scanning method to report the tax. Staff further recommends deleting the language urging grocers to seek Board approval prior to using the modified purchase ratio and the cost plus markup methods of reporting the tax.

The proposed revisions are attached as Exhibit 2.

III. Other Alternative Considered

Do not revise Regulation 1602 .5.

IV. Background

Regulation 1602.5 provides that in preparing sales and use tax returns, grocers may use any method of determining the amount of their sales of exempt food products which does not result in an overstatement of the exemption. Grocers must be prepared to demonstrate by records, which can be verified by audit, that the method used properly reflects their sales of exempt food products. Although the list of methods is not exhaustive, subdivision (b) of the regulation describes the following acceptable methods for reporting the tax: the purchase-ratio method; the modified purchase-ratio method; the retail inventory method and markup method; and the electronic scanning systems method. Regulation 1602.5 is available at http://www.boe.ca.gov/pdf/reg1602-5.pdf.

Electronic scanning systems use electronic scanners and central computers to automatically compile and record taxable and nontaxable sales, sales tax, and related data from scanning the Universal Product Code (UPC) on products. Under the electronic scanning system method of reporting, grocers use the information generated from these systems to complete their sales and use tax returns.

Regulation 1602.5 was amended in 1995 to recognize electronic scanning systems as an acceptable reporting method for grocers, subject to certain record keeping requirements. In 2000, Audit Manual sections 0912.00 et seq. incorporated record keeping guidelines for grocers using scanning systems and the procedure to follow in obtaining approval for its use. This procedure includes a review of the reporting procedures to determine if they are consistent with the record keeping guidelines. These sections of the audit manual are available at http://www.boe.ca.gov/pdf/fam-09.pdf.

At the time the regulation was updated in 1995, the use of scanners was a relatively new technology and there was a need to standardize and define what type of documentation was necessary to support reported taxable and nontaxable sales and verify the accuracy of the reporting system. Therefore, language was added to the regulation requiring grocers who were contemplating use of an electronic scanning system as a reporting method to notify the Board and submit a general outline of the proposed procedures for review and approval before using this reporting method.

In addition, since its adoption in 1973, Regulation 1602.5 included provisions that urge grocers contemplating use of the modified purchase-ratio method and the cost plus markup method to notify the Board of such intentions and to submit a general outline of the proposed procedures for approval prior to use of such procedures. However, there is no requirement to do so.

Upon review of the above provisions, staff found them to be obsolete and proposed removing them to update the regulation. Staff and interested parties met on April 22, 2008, to discuss the issue. Interested parties agreed with the proposed revisions. Since there was agreement concerning the revisions, the Committee meeting date for this topic has been changed from August 19, 2008 to July 8, 2008. In addition, the second meeting with interested parties on this topic, previously scheduled for June 10, 2008, was cancelled.

V. Alternative 1 - Staff Recommendation

A. Description of Alternative 1

- Subdivision (b)(4): Eliminate the provision requiring grocers to obtain Board approval before using an electronic scanning method to report the tax. (See Exhibit 2.)

- Subdivisions (b)(2) and (b)(3)(B)2.G.: Delete the language urging grocers to seek advance Board approval prior to using the modified purchase ratio and the cost plus markup methods of reporting the tax. (See Exhibit 2.)

Discussion - Subdivision (b)(4)

According to records maintained by the Board, approximately thirteen grocers requested and received Board approval to use the electronic scanning system since 1995. Prior to 1995, many more grocers voluntarily requested review and approval of their procedures to use electronic scanning systems. Given the current widespread use of electronic scanning systems, staff believes that there are grocers who currently report the tax using the electronic scanning system without having submitted and received prior Board approval.

As a matter of policy, the Board has not restricted the use of such electronic scanning systems for reporting purposes when approval was not obtained in advance. In part, this is because grocers can use any method of determining the amount of their sales of exempt food products that does not result in an overstatement of the exemption and because grocers must maintain the records necessary to demonstrate that the method used properly reflects their sales of exempt food products. Given the current widespread use and standardization of electronic scanning systems; the fact that all requests for Board approval were reviewed and granted; and the fact that Board policy does not restrict the use of electronic scanning system when grocers fail to obtain approval prior to using this method, staff believes the approval requirement in the regulation is no longer necessary and should be eliminated. The California Grocers' Association (CGA) concurs with these proposed revisions.

Regulation 1698, *Records*, explains the general record keeping requirements for all retailers. Audit Manual section 0912.20 provides a list of records that should be developed and retained by grocers reporting tax by use of electronic scanners. The list includes the master listings (UPC, product's taxable or nontaxable status, etc.), product coding reports (additions and deletions of products, coding changes of existing products, etc.), product movement report, and a general outline of the electronic scanner reporting methods including the type and form of records and reports generated and a description of who is responsible for testing, maintaining, and correcting the scanning system.

After discussing the possibility of incorporating these record keeping requirements in the regulation, staff and CGA agree that they are better fit for the Audit Manual and Publication 31, "Tax Tips for Grocers," since CGA informed staff that it, and its member grocers, are more likely to look to the Audit Manual and publication for guidance.

Discussion - Subdivisions (b)(2) and (b)(3)(B)2.G

As discussed above, Regulation 1602.5 urges grocers contemplating use of the modified purchase-ratio method or the cost plus markup method to notify the Board of such intentions and to submit a general outline of the proposed procedures for approval prior to use of such procedures. Board approval for these two methods also specifies the period within which such procedures are authorized for use, typically to coincide with the next anticipated audit period.

The modified purchase-ratio method in subdivision (b)(2) of the regulation is based on the purchase-ratio method, under which grocers may claim as sales of exempt food products that proportion of their total sales of grocery items that the amount of their purchases of exempt food products bears to their total purchases of grocery items. Any grocer who reports on a purchase ratio basis of some type but deviates from the procedures outlined in the regulation is deemed to be using the modified purchase-ratio method.

The cost plus markup method in subdivision (b)(3)(B) of the regulation is used primarily by grocers who engage in manufacturing, processing, warehousing, or transporting their own products, and is based on marking up the cost of all taxable merchandise to the anticipated selling prices at the time of purchase.

These methods of reporting and the directions provided to grocers who elect to use such methods, including the invitation to seek advance Board review and approval of the reporting procedures, were developed in cooperation with CGA and other representatives of industry in 1973 to ensure the procedures used by grocers were adequate and that they did not result in an understatement or overstatement of the food products exemption.

Board records indicate that, for a period of time after the adoption of the regulation in 1973, grocers routinely requested Board review and approval for the use of the modified purchase-ratio method or the cost plus markup method. However, the number of requests to use these methods declined with time and none have been received in the last 15 years.

Therefore, staff and CGA agree that the language in the regulation urging grocers to seek advance Board approval before using these methods is no longer applicable and should be deleted. The proposed revisions would still allow grocers, who wish to do so, to consult with the Board to ensure the procedures they use or plan to use are adequate and do not result in an overstatement of the food product exemption.

B. Pros of Alternative 1

- Would reduce a grocer’s burden to comply with the law.
- Would eliminate outdated regulatory requirements.

C. Cons of Alternative 1

None.

D. Statutory or Regulatory Change for Alternative 1

No statutory change is required. However, staff’s recommendation does require the amendment of Regulation 1602.5.

E. Operational Impact of Alternative 1

Staff would notify taxpayers of the amendments to Regulation 1602.5 through an article in the Tax Information Bulletin (TIB).

F. Administrative Impact of Alternative 1

1. Cost Impact

There will be no additional costs. The workload associated with publishing and distributing the TIB and revising Publication 31 and Audit Manual Chapter 9 are considered routine and any corresponding cost would be within the Board's existing budget.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact of Alternative 1

Since the proposed amendments to the regulation would reduce a grocer's burden to comply with the law and would eliminate a regulatory requirement that appears to be outdated, staff expects that this regulation will improve compliance.

H. Critical Time Frames of Alternative 1

None. Implementation will occur 30 days after approval by the Office of Administrative Law.

VI. Alternative 2 – No Revisions

A. Description of Alternative 2

Do not revise Regulation 1602.5.

B. Pros of Alternative 2

Revisions to update the procedures in the regulation could be viewed by some as unnecessary.

C. Cons of Alternative 2

- The regulation would be outdated.
- Taxpayers who do not request Board approval will continue to be out of compliance with the regulation.

D. Statutory or Regulatory Change for Alternative 2

None.

E. Operational Impact of Alternative 2

None.

F. Administrative Impact of Alternative 2

1. Cost Impact

None.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact of Alternative 2

The outdated provisions may lead to confusion among taxpayers. In addition, a grocer's burden to comply with the law would not be reduced.

H. Critical Time Frames of Alternative 2

None.

Preparer/Reviewer Information

Prepared by: Tax Policy Division, Sales and Use Tax Department

Current as of: July 20, 2008

REVENUE ESTIMATE

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

BOARD OF EQUALIZATION
REVENUE ESTIMATE

Proposed revisions to Regulation 1602.5, *Reporting Methods for Grocers*, Regarding the Use of the Electronic Scanning Systems

Alternative 1 – Staff Recommendation

As agreed upon by staff and industry representatives, staff recommends that the Board authorize publication of the proposed amendments to Regulation 1602.5 as illustrated in Exhibit 2. Staff recommends eliminating the requirement that grocers get Board approval before using an electronic scanning method to report the tax. Staff further recommends deleting the language urging grocers to seek Board approval prior to using the modified purchase ratio and the cost plus markup methods of reporting the tax.

Other Alternative Considered

Do not revise Regulation 1602.5.

Background, Methodology, and Assumptions

<u>Alternative 1 – Staff Recommendation</u>

There is nothing in staff recommendation that would impact sales and use tax revenue. Staff recommendation removes obsolete regulatory language no longer required.

<u>Alternative 2 – Other Alternative Considered</u>

There is nothing in the alternative 2 that would impact sales and use tax revenue.

Revenue Summary

Alternative 1 – staff recommendation does not have a revenue impact.

Alternative 2 – alternative 2 does not have a revenue impact.

Preparation

Mr. Bill Benson, Jr., Research and Statistics Section, Legislative and Research Division, prepared this revenue estimate. Mr. Dave Hayes, Manager, Research and Statistics Section, Legislative and Research Division, and Mr. Jeff McGuire, Tax Policy Manager, Sales and Use Tax Department, reviewed this revenue estimate. For additional information, please contact Mr. Benson at (916) 445-0840.

Current as of June 18, 2008.

Regulation 1602.5. Reporting Methods for Grocers.

(a) FOOD PRODUCTS EXEMPTION — IN GENERAL. Tax does not apply to sales of food products for human consumption. Accurate and complete records of all purchases and sales of tangible personal property must be kept to verify all exemptions claimed as sales of exempt food products.

In preparing returns, grocers may use any method of determining the amount of their sales of exempt food products which does not result in an overstatement of the exemption. Grocers must be prepared to demonstrate by records which can be verified by audit that the method used properly reflects their sales of exempt food products.

(b) REPORTING METHODS.

(1) PURCHASE-RATIO METHOD. One method which may be used is the purchase-ratio method sometimes referred to as the "grocer's formula". Under this method, grocers may claim as sales of exempt food products that proportion of their total gross receipts from the sale of "grocery items" that the amount of their purchases of exempt food products bears to their total purchases of grocery items.

If the grocer elects to use the purchase-ratio method of reporting, the following criteria should be followed:

(A) The purchase-ratio method may be used only by grocers and only with respect to sales of "grocery items".

(B) Grocers selling clothes, furniture, hardware, farm implements, distilled spirits, drug sundries, cosmetics, body deodorants, sporting goods, auto parts, cameras, electrical supplies, appliances, books, pottery, dishes, film, flower and garden seeds, nursery stock, fertilizers, flowers, fuel and lubricants, glassware, stationery supplies, pet supplies (other than pet food), school supplies, silverware, sun glasses, toys and other similar property should not include the purchases and sales of such items in the purchase-ratio method. These items are referred to as "nongrocery taxable" items.

When the purchase-ratio method is used for reporting purposes and sales of nongrocery taxable items are computed by the retail extension or markup method, the computation of nongrocery taxable sales should include adjustments for beginning and ending inventories of these items and may include adjustments for shrinkage as specified in (d) below.

(C) Grocers selling gasoline, feed for farm animals, farm fertilizers or who operate a snack bar or restaurant, or sell hot prepared food should not include the purchases and sales of such items or operations in the purchase-ratio method.

(D) The purchases and sales of meat, fruit, produce, delicatessen (except hot prepared food or food sold for immediate consumption at facilities provided by the grocer), beverage (except distilled spirits in the liquor department) and bakery departments must be included in the purchase-ratio method if these departments are operated by the grocer.

(E) The records should be complete and adequate and all sales and purchases should be properly accounted for in the records. All purchases of exempt food products, grocery taxable items and nongrocery taxable items should be segregated into their respective classifications.

(F) The following definitions apply to the purchase-ratio method:

1. "Exempt food products" means those items generally described as food products in Section 6359 and Regulation 1602. If grocers are uncertain as to the classification of any product, they should contact the nearest board office.

2. "Total gross receipts from the sale of grocery items" means the total amount of the sales price of all exempt food products and taxable grocery items, including sales tax reimbursement, amounts receivable from manufacturers, or others, for coupons (excluding any handling allowances) redeemed by customers, and the face value of federal food stamps. The term does not include receipts from sales of those items described in (b)(1)(B), above, which are commonly referred to as "nongrocery taxable items", or from those sales described in (b)(1)(C), above (gasoline, snack bar, etc.). It does not include amounts which represent "deposits", as defined in Regulation

1589, e.g., bottle deposits. When deposits are not segregated, it will be presumed, in the absence of evidence to the contrary, that the total deposits received are equal to the deposits refunded.

3. "Grocery items" means exempt food products and taxable items other than those generally classified under (b)(1)(B) and (b)(1)(C), above.

4. "Purchases" means the actual amount which a grocer is required to pay to the suppliers of merchandise, net of any cash discounts, volume rebates or quantity discounts and promotional allowances. The term does not include the cost of transportation, processing, manufacturing, warehousing, and other costs, if these operations are self-performed. It does not include the cost of operating supplies such as wrapping materials, paper bags, string, or similar items. It does not include amounts which represent "deposits", as defined in Regulation 1589, e.g., bottle deposits (see (b)(1)(F)2., above). If deposits are not segregated, it will be presumed, in the absence of evidence to the contrary, that the amount deposited with the supplier is equal to the credit received for bottles returned by the grocer.

A. As used herein, the term "cash discount" means a reduction from the invoice price which is allowed the grocer for prompt payment.

B. As used herein, the term "volume rebate or quantity discount" means an allowance or reduction of the price for volume purchases based on the number of units purchased or sold. Such rebates or discounts normally are obtained without any specific contractual obligation upon the part of the grocer to advertise or otherwise promote sales of the products purchased. The term does not include patronage dividends distributed to members by nonprofit cooperatives pursuant to Section 12805 of the Corporations Code, or rebates which constitute a distribution of profits to members or stockholders.

C. As used herein, the term "promotional allowance" means an allowance in the nature of a reduction of the price to the grocer, based on the number of units sold or purchased during a promotional period. The allowance is directly related to units sold or purchased although some additional promotional expense may be incurred by the grocer. Normally, grocers would feature the product in their advertising, although they may or may not be contractually obligated to do so. The retail price of the product may or may not be lowered during a promotional period.

The term does not include display or other merchandising plan allowances or payments which are based on agreements to provide shelf space for a price not related to volume of purchases, or cooperative advertising allowances which are based on a national line rate for advertising and are not directly related to volume of purchases and sales. Cooperative advertising allowances are intended to reimburse grocers for a portion of their advertising costs for a particular product or products.

(G) Sales tax reimbursement collected in accordance with Regulation 1700 which is included in total sales is an allowable deduction. An example of the computation of the purchase-ratio method which provides for an adjustment for sales tax included follows:

1. Taxable grocery purchases	$40,000	
2. Add sales tax adjustment (6%* x Item 1)	2,400	
3. Adjusted taxable grocery purchases (Item 1 + Item 2)	42,400	
4. Exempt food products purchases	130,000	
5. Total grocery purchases including sales tax (Item 3 + Item 4)	172,400	
6. Exempt food products ratio (Item 4 divided by Item 5)		75.41%
7. Total sales including sales tax	254,088	
8. Nongrocery taxable sales including sales tax (if such sales are not accurately segregated, mark up nongrocery taxable cost of goods sold to compute sales — add 6%* sales tax to total)**	31,500	
9. Grocery sales including sales tax (Item 7 - Item 8)	222,588	
10. Exempt food products sales (Item 6 x Item 9)	167,854	
11. Sales of taxable items including sales tax (Item 7 - Item 10)	86,234	
12. Less taxable items purchased with food stamps (2% of total food stamps redeemed for period, e.g., 2% x $100,000)	2,000	
13. Taxable Measure including sales tax (Item 11 - Item 12)	84,234	
14. Sales tax included (6/106* x Item 13)	4,768	
15. Measure of tax (Item 13 - Item 14)	79,466	
16. Sales tax payable (6%* x Item 15)	4,768	

(2) MODIFIED PURCHASE-RATIO METHOD. Any grocer who does not follow the procedure outlined in (b)(1), above, but reports on a purchase-ratio basis of some type is using a modified version of the purchase-ratio method. For example, grocers who include self-performed processing, manufacturing, warehousing or transportation costs in the purchase-ratio formula are using a modified version. Grocers using such a modified version must establish that their modified version does not result in an overstatement of their food products exemption. They may demonstrate the adequacy of their modified method by extending taxable purchases, adjusted for inventories, to retail for a representative period or computing taxable sales by marking up taxable purchases, adjusted for inventories, for a representative period. Grocers must retain adequate records which may be verified by audit, documenting the modified purchase-ratio method used. ~~Grocers contemplating use of a modified purchase-ratio reporting method are urged to notify the board of such intentions and to submit such methods to the nearest board office for review prior to use of such methods. Grocers submitting proposed modified purchase-ratio reporting methods meeting board approval will be furnished written notice indicating the period within which such modified methods are authorized for use.~~

(3) RETAIL INVENTORY METHOD AND MARKUP METHOD. Grocers who engage in manufacturing, processing, warehousing or transporting their own products may prefer to use a retail or markup method of reporting. These methods are described below:

(A) Retail Inventory Method.

1. The opening inventory is extended to retail and segregated as to exempt food products and taxable merchandise.

2. As invoices for merchandise are received, they are extended to retail and segregated as to exempt food products and taxable merchandise.

3. The ending inventory at retail is segregated as to exempt food products and taxable merchandise.

* Use applicable tax rate — tax rate of 6% used for illustration purposes.
** Adjust for shrinkage if applicable — see paragraph (d).

4. The total of segregated amounts determined in 1 and 2 less 3 represent anticipated exempt and taxable sales.

5. The segregated amounts determined in 4 are adjusted for net markons, net markdowns, and shrinkage to determine realized exempt and taxable sales.

6. Physical inventories are taken periodically to adjust book inventories.

(B) Cost Plus Markup Method — Taxable Merchandise.

1. The cost of all taxable merchandise is marked up to anticipated selling prices at the time of purchase. Records are kept of net markons, net markdowns, and shrinkage for all taxable merchandise. Such records are used to adjust the anticipated selling price to the realized price. Inventory adjustments are required unless the inventory of taxable merchandise at the beginning and ending of reporting periods is substantially constant. Returns should reflect as taxable sales the realized selling price of all taxable merchandise during a reporting period (anticipated sales price on purchases adjusted for inventory changes and other adjustments of the types mentioned).

2. If the grocer elects to use the cost plus markup method of reporting, the following criteria should be followed:

A. Markup factor percentages[1] applicable to taxable merchandise should be determined by a shelf test sample of representative purchases, covering a minimum purchasing cycle of one month within a three-year period, segregated by commodity groupings, i.e., beer, wine, carbonated beverages, tobacco and related products, paper products, pet food, soap, detergents, etc. The markup factor percentages determined for commodity groupings should be applied to the cost of sales of the respective commodities for the reporting to determine taxable sales.

In order to insure that markup factor percentages typical of the total business are determined, grocers who conduct multistore operations should include purchases from several representative stores in the shelf test sample of markup factor percentages.

B. As an alternate procedure to A., above, the overall average markup factor percentage for all taxable commodity groupings may be used to determine taxable sales for the reporting period. This markup factor percentage is applied to the overall cost of taxable sales for the reporting period.

The overall average markup factor percentage should be determined as follows:

a. Determine markup factor percentages by commodity groupings based on shelf tests covering a minimum purchasing cycle of one month within a three-year period.

b. Determine cost of sales, segregated by commodity groupings, for a representative one-year period.

c. Apply markup factor percentages (Step a) to the cost of sales of the respective commodity groupings (Step b) to determine anticipated sales by commodity groupings and in total.

d. Divide total anticipated sales (Step c) by the respective total cost of sales to determine the overall average markup factor percentage.

C. In calculating markup factor percentages, appropriate consideration should be given to markon and markdown price adjustments, quantity price adjustments such as on cigarettes sold by the carton, liquor sold by the case and other selling price adjustments. Quantity and other price adjustments may be determined by a limited test of sales of a representative period or by sales experience of a representative store within the operating entity.

D. The computation of taxable sales for the reporting period should be based on cost of sales for the period. If for any particular reporting period or periods, cost of sales is not determinable because actual physical inventories are unknown and inventories remain substantially constant, the computation of taxable sales may be based on purchases for the period. However, if inventories are not substantially constant, adjustments for physical inventories should be taken into consideration in one of the reporting periods occurring within the accounting year.

[1] Markup factor percentage is the markup + 100%. When applied to cost, it computes the selling price. For example, an item costing $1.00 and selling at a 25% markup will have a markup factor of 125%. The markup factor (125%) when applied to $1.00 cost results in a $1.25 selling price.

E. Shrinkage should be adjusted as specified in (d) below.

F. Taxable markup factor percentages based on shelf test samples will generally be considered valid for reporting purposes for a period of three years, provided business operations remain substantially the same. A substantial change in business operations will be considered as having occurred when there is a significant change in pricing practices, commodities handled, commodity mix, locations operated, sources of supply, or other circumstances affecting the nature of the business.

~~G. Grocers contemplating use of the cost plus markup method of reporting are urged to notify the board of such intentions and to submit a general outline of proposed markup procedures to the nearest board office for review prior to use of such procedures. Grocers submitting proposed markup procedures meeting board approval will be furnished written notice indicating the period within which such procedures are authorized for use.~~

(4) ELECTRONIC SCANNING SYSTEMS. The use of a scanning system is another acceptable reporting method for grocers. Electronic scanning systems utilize electronic scanners and central computers to automatically compile and record taxable and nontaxable sales, sales tax, and related data from scanning of products imprinted with the Universal Product Code. It is the grocer's responsibility to establish the propriety of reported amounts. Grocers must ensure that proper controls are maintained for monitoring and verifying the accuracy of the scanning results and tax returns. Adequate documentation must be retained which may be verified by audit, including all scanning programs relating to product identity, price, sales tax code, program changes and corrections to the programs. Records which clearly show a segregation of taxable and nontaxable merchandise purchases would provide an additional source from which the scanning accuracy may be monitored or verified.

~~Grocers contemplating use of electronic scanning systems results as a reporting method are required to notify the board of such intentions and to submit a general outline of the proposed procedures to the board for review and approval prior to adoption of such method for reporting purposes. Grocers submitting proposed scanning system procedures meeting board approval will be furnished written notice indicating the period within which such procedures are authorized for use.~~

(c) FOOD STAMPS. Tangible personal property eligible to be purchased with federal food stamps and so purchased is exempt from the tax. Grocers who receive gross receipts in the form of federal food stamp coupons in payment for such tangible personal property which normally is subject to the tax, e.g., nonalcoholic carbonated beverages, may deduct on each sales tax return an amount equal to two percent (2%) of the total amount of food stamps redeemed during the period for which the return is filed. Effective January 1, 1993, grocers may claim amounts in excess of two percent whenever the following computation results in a greater percentage: total purchases of taxable items eligible to be purchased with federal food stamps divided by an amount equal to the total of the exempt food product purchases as defined in subdivision (b)(1)(F)1 plus the purchases of taxable items eligible to be purchased with federal food stamps. For example, for a reporting period, if the total purchases of carbonated beverages equals $5,000 and the total purchases of exempt food products equals $130,000, a percentage of 3.7% ($5,000 ÷ $135,000) may be used in computing the allowable food stamp deduction for that period. This deduction may be taken in lieu of accounting separately for such sales.

(d) SHRINKAGE. As used herein, the term “shrinkage” means unaccounted for losses due to spoilage, breakage, pilferage, etc. Grocers who incur such losses, may, for reporting purposes, adjust for such losses as follows:

(1) An adjustment of up to 1 percent of the cost of taxable merchandise may be taken into consideration when the retail inventory or markup method is used for reporting purposes.

(2) An adjustment of up to 3 percent of the cost of nongrocery taxable items may be taken into consideration when the purchase-ratio method is used for reporting purposes and sales of nongrocery taxable items are computed by the retail extension or markup method. The adjustment is limited to an overall 1 percent of taxable purchases when other than the purchase-ratio method is used for reporting purposes.

Losses in excess of the above are allowable when supported by records which show that a greater loss is sustained.

(e) LIST OF METHODS NOT EXHAUSTIVE. The methods by which grocers may determine their sales of exempt food products are not limited to the methods described above. Grocers may use any method which they can support as properly reflecting their exempt food sales. As is the case for all exemptions, it is the grocer's responsibility to establish the propriety of the amount of the claimed exemption.

(f) AUDITS. Taxpayers using one of the approved methods of reporting described in this regulation will normally be audited by application of the same approved procedure in the audit to verify the accuracy of claimed deductions. However, determinations may be imposed or refunds granted if the board, upon audit of the retailer's accounts and records, determines that the returns did not accurately disclose the amount of tax due.