

BEFORE THE INTERPRETATION AND APPEALS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition ) D E T E R M I N A T I O N  
For Correction of Assessment of )  
) No. 89-53  
  
)  
. . . ) Registration No. . . .  
) . . . /Audit No. . . .  
)

- [1] **RCW 82.32.070:** TAX LIABILITY -- DUTY TO KEEP AND PRESERVE RECORDS -- FAILURE TO PRODUCE DOCUMENTATION. Persons engaged in business are required to keep adequate records or are estopped to question a Department assessment of tax during an audit or a later proceeding. Where taxpayer produces no daily sales records of operations or records of sales from street fairs in which the business participated, the auditor's assessments based on visual observations and conversations with taxpayer's landlords and fair organizers must be upheld.
- [2] **RULE 102 and RULE 178:** RETAIL SALES TAX -- USE TAX -- RESALE CERTIFICATE. Persons purchasing taxable items for their own use are required to pay sales tax at the time of the purchase or use tax at the time of the item is used. Taxpayer carries the burden of proving entitlement to exemption from taxability. Where a resale certificate is improperly used or where receipts are not produced showing separate statement of sales tax paid, taxpayer is liable for use tax on the items purchased.
- [3] **RCW 82.32.050:** EVASION PENALTY -- RETAIL SALES AND USE TAX. The statutory evasion penalty applies where circumstances as a whole show that taxpayer intended to evade tax laws. Where taxpayer was registered with the Department and paid some taxes for several years, and where there is evidence of

consistent underreporting of sales, improper use of a resale certificate and fabrication of sales invoices which were then submitted to the auditor to show that retail sales tax was paid, assessment of the evasion penalty on those portions of the assessment is upheld.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

TAXPAYER REPRESENTED BY: . . .  
. . .

DATE OF CONFERENCE: January 17, 1989

#### NATURE OF ACTION:

Taxpayer petitions for correction of assessment of tax on underreported sales, stating that the methodology used by the auditor in determining sales amounts is incorrect and for cancellation of the evasion penalty on the grounds that taxpayer did not intend to act dishonestly.

The remainder of the items on which tax was asserted were not protested, because taxpayer felt that they were a very small part of the overall assessment.

#### FACTS AND ISSUES:

Johnson, A.L.J. -- Taxpayer is registered as a partnership and engages in the fast-food restaurant business. The partnership was initially set up by the above-mentioned taxpayer and her sister; however, the sister has ceased to participate, and [the party represented at the hearing] is running the partnership alone. She will hereinafter be referred to as the taxpayer. The audit covers the period from January 1, 1984, through March 31, 1988.

The business began operations as a small grocery in the [location 1], featuring foods from taxpayer's native country. After some time, limited seating was added. Taxpayers began selling the fast-food lunch items currently available, such as hot noodles. The nature of the business is generally take-out food consumed by persons shopping in the area. Sometime before 1984, taxpayer opened a second location [location #2] near the University of Washington. This location was closed for several months in 1987, when the business lost that lease;

taxpayer contends that business resumed in September, 1987; but the audit report states that it resumed "around March" of 1987. Also in 1987, taxpayer opened three Seattle locations: [location #3], a busy Capitol Hill arterial; at [location #4]; and in the shopping area at [location #5, a large] office building.

Until the time of the audit, taxpayer used a small, manual cash register at each location. Sales were rung up by the total amount, which included any tax charged. No cash register tapes were used. Taxpayer kept a notebook with one page for each month and daily totals written in and states that the figure listed for each day represents the total gross for all sites that were operating at the time of the entry. Lacking records from which to determine sales figures, the auditor contacted taxpayer's landlords. Taxpayer complains that, where the landlords estimated her sales, the figures were "guesses by nonfood business individuals and tend to contradict the information that the landlord originally accepted as valid, in regard to a lease based on the gross receipts." Additionally, the petition states that the auditor conducted on-site observations during the locations' busiest periods and attributed such sales volume to all hours of operation.

Also during the audit period, taxpayer participated in a number of local fairs, including the Bite of Seattle, Bumbershoot, the Northwest Folklife fair, the University District street fair, the Pike Place Market street fair, Bite of Edmonds, the Fremont street fair, the International District fair and the Heritage fair. The fairs vary in size and duration, and the listing above is organized by size from largest to smallest. A large fair, such as the Bite of Seattle, attracts an estimated 300,000 persons during its run; this is attributable both to its popularity and to the large open grounds of the Seattle Center, where it is held. A fair such as the Pike Place Market's is limited in size, because of the space constraints dictated by its geographic location; the Pike Place Development Association estimates that approximately 100,000 people visit the area during the two-day run. Taxpayer repeated participation in some fairs but not others, depending on her success at each one. During the hearing in this matter, taxpayer and her representative stated that the issue is no longer whether taxpayer participated in the years for which tax is asserted; the remaining issue is only the figures on which the auditor asserted the tax.

Taxpayer contests the auditor's estimated amounts for several of the "small" fairs, pointing out, for example, that the \$10,000 figure arrived at for the four years of participation in the Pike Place Market's two-day fair match the figures estimated for Bite of Seattle sales in 1987. That year's figures were adjusted somewhat for various difficulties experienced by the taxpayer in operating at the site.

During the hearing in this matter, taxpayer's representative presented a copy of the audit report on which the figures appeared; he asked taxpayer "what she would feel comfortable with" as being accurate figures of the sales from each fair. The effect of naming the acceptable figures was that taxpayer wants the figures reduced by 50%-75% in the case of all of the small fairs and by a similar amount for the two years in which it participated in the Bite of Seattle. Coincidentally, the contested fairs are those from which no concrete figures are available from either the taxpayer or the fair organizers. No proof of sales was submitted at the hearing other than the contention that the figures used were too high and that a lower figure would be more acceptable.

Taxpayer, over the course of the audit period, purchased restaurant equipment for use in her business. Some of the purchases were found to have been made using a resale certificate, which permits persons buying items for resale to pay no tax on their purchases. Many of the purchases were made with cash and virtually no receipts were retained by the taxpayer; the auditor assessed use tax on the purchases, as no proof was submitted to show payment of sales tax at the time of purchase.

During the course of the audit conferences, receipts were produced by the taxpayer, which were purportedly prepared by the restaurant equipment purveyor and which appeared to show that tax was paid. Upon confrontation with the fact that the receipts were confirmed to be false by the equipment seller's bookkeeper, taxpayer contended that she was so frightened that she permitted an unidentified friend to manufacture the receipts for her. She states that her purpose was only to have something to show the auditor, not to "cheat" on her taxes.

Taxpayer was visibly distressed during the hearing in this matter and repeatedly stressed that she never intended to "cheat" on her taxes. She spoke at length about the difficulties of starting and successfully operating any small business and particularly a fast-food restaurant outlet. She

described her activities as "survival," stating that she made all of the sauces used at the outlets and was primarily concerned with daily problems, such as product and supply levels, and "worrying about the health inspector." She contends that she started out just trying to make it from day to day and that she was unfamiliar with how she should have been keeping records, that the state never told her how it was done, and that no one--the state or other fair participants--ever informed her that proceeds from the fair activities were taxable.

She acknowledges that falsification of the purchase invoices was wrong, but states that she felt that the auditor approached the audit with a preconceived notion of the result to be achieved, that she felt that the auditor's methods were "intimidating and humiliating" and that she felt afraid and produced the manufactured invoices in an effort to have something to show the auditor.

## I. THE AUDIT

### SALES AT THE FOOD OUTLETS

Due to the lack of records on the taxpayer's part, the auditor turned to other sources to obtain information on what accurate figures for taxpayer's sales at its locations and the fairs were and for proof of payment of sales tax on equipment purchases. The auditor also found that taxpayer had conducted much of her business by paying cash and writing checks only where necessary and that records of deposits provided by her bank were for amounts lower than taxpayer's own notebook showed. As a result, bank records were of little use as documentation of taxpayer's income or expenses.

For assistance in determining sales figures for the various outlets, the auditor met with each landlord. If the lease required reporting of sales figures, and if the figures were still available, this information was collected. The auditor also conducted an on-site observation at each site and compared the totals obtained in this manner to the available figures supplied by the landlords and the taxpayer's notebook.

#### A. [LOCATION #1's] SALES

At the market, the auditor was told that underreporting of sales was suspected by the current property manager, who commenced her employment in August, 1985; the auditor was also told that the prior property manager also suspected underreporting and had even conducted his own observation of

the operation. Additionally, the lease permits the property manager to audit the businesses periodically to determine whether sales are being correctly reported. A national firm was engaged to perform such an audit sometime before a 1985 rent increase; the auditors in that case also suspected underreporting, but taxpayer's complete lack of records made confirmation of figures impossible. However, after the audit, the current property manager tripled taxpayer's rent without argument from the taxpayer, further implying to the landlord that taxpayer had sales sufficient to cover the increased costs.

B. [LOCATION #5's] SALES

The property manager at this location also expressed suspicion that sales figures are underreported and bases such suspicion on his own personal observation of the operation and on his opinion that the figures are too consistent in amount, without predictable fluctuations. Although he believes the figures are low, he feels that they are within an acceptable range and has not taken any action. The auditor conducted her own observation and found that figures developed from the observation were fairly accurate; as a result, they were accepted at face value for purposes of the audit.

C. [LOCATION #2's] SALES

Figures for these locations, both the original one and the one leased from 1987 on, are unavailable. Taxpayer changed landlords; the first one had records for the first nine months of 1984 only, and the current landlord had no figures available. Due to the lack of records available for taxpayer or the landlords, the auditor compared estimates derived from her personal observation with the taxpayer's notebook. The observation estimate, at \$756 in average daily sales, is considerably higher than the notebook's highest average of \$443; additionally, the notebook's figure is purportedly a combined total for at least the [#1] and the [#2] locations. The auditor was aware that the operating hours at this location are longer and that it is open on Sundays, both of which are different than the schedule followed at [location #1].

D. [LOCATION #3]

The figures available were submitted by taxpayer to the property management company after the initial meeting between taxpayer and the auditor. The handwritten note to the property manager cites a list of grievances and

inconveniences. The auditor noted that, due to a lack of clear documentation, she used figures obtained from her own observation and from the [#2] site and reduced them to allow for lower sales volume during the outlet's first three months of operation. The auditor's conclusion was that the estimated figures were reasonable, and they were used in the audit.

#### E. [LOCATION #4]

This lease is not based on a percentage of the sales, so no figures are required by the landlord. Again using the [location #2] figures as a base, the auditor allowed a reduction for the initial months of operation and conducted an on-site observation; the figures were, again, found to be reasonable.

The auditor pointed out in her report that taxpayer's claim that the notebook figures represented sales for all locations was, upon analysis, "ludicrous." In Exhibit E to the audit, the auditor prepared a table that assumed acceptance of the notebook figures and the amounts reported to the [location #1] and [location #5] landlords. She concluded that, in reconciling the sales reported, the [location #5] sales would have to have been overlooked in 1987 and that [location #4] and [location #3] could not have had sales between their 1987 openings and the end of the audit period in March, 1988.

The audit was subsequently adjusted after the auditor made further observations, reviewed actual sales records for each location for the month of June, 1988, and reviewed additional information supplied by the [location #1] and [location #5] landlords.

#### SALES AT THE FAIRS

Taxpayer participated in the fairs listed previously and discontinued participation in fairs that proved unprofitable. The auditor noted that no records were kept to document sales during the fair periods and that taxpayer never reported any sales from the fairs for excise or sales tax purposes. Because of the lack of records, the auditor consulted with the organizers and personnel of the street fairs themselves.

The fair organizers seemed to be in agreement that fairs such as Bumbershoot, the Folklife festival, and Bite of Seattle, all of which are three days, are considered to be "big" fairs. Those held at the Pike Place Market, Fremont, the University district, Edmonds, (all two-day fairs), Heritage at Marymoor

Park (two-three days) and the International district (one day) are considered to be "small."

Most of the fairs did not require submission of sales figures by participants or base their rental charges on such figures; as a result, the auditor was forced to rely on the organizers' estimates of daily sales. The original exception was the Folklife festival, which reported that taxpayer's stated sales were \$14,296 for the single year in which she participated. The figures used were adjusted where necessary upon receipt of actual sales figures made available by Bumbershoot and Heritage and upon organizers' verification of taxpayer's actual years of participation. The Heritage fair organizer stated his opinion that festival participants average total sales of \$3,000-\$4,000 for the two-day period; when he actually was able to supply figures, taxpayer's submitted figures were \$2,571, \$3,785 and \$4,238 for the three years of participation. These amounts closely match the organizer's opinion of average sales.

#### PURCHASES OF EQUIPMENT

##### A. RESALE CERTIFICATE

During the audit period, taxpayer made several purchases of equipment from one purveyor using a resale certificate. No receipts were presented to the auditor, who then relied on receipts from the purveyor's records to establish that no sales tax was paid on the purchases for which the purveyor had duplicate receipts.

##### B. ADDITIONAL SALES

In several other cases, the file contains copies of invoices which state that tax was paid. The auditor questioned their validity; and, upon presentation to the purveyor for confirmation, was told that the receipts did not originate with the purveyor. A statement by the purveyor's bookkeeper is contained in the audit file as Exhibit E. It states that "it became obvious to me that the invoices presented to me were altered or fabricated altogether. I assume one of our original invoices was used to copy." The bookkeeper noted that the invoices described equipment and prices differently from the purveyor's own invoices, that the numerical sequencing differed, and that the handwriting was unfamiliar.



Based on the invoices and the irregularities found, the auditor concluded that the taxpayer created the invoices as evidence that tax had been paid, stating that

Taxpayer has purposefully tried to deceive an official government taxing authority with the willful intent to evade taxes which are properly due. The credibility of taxpayer's records and any statements made pertaining to the business has been reduced to a minuscule level.

Consequently, if the taxpayer has taken such extreme measures to avoid the payment of tax, it can be surmised that the taxpayer knowingly underreported sales on the state excise tax returns.

The auditor disputed taxpayer's claim that she did not understand business operations and considered the difficulty of succeeding in the fast-food business, in which costs must be "closely monitored in order to show any measure of profit." The audit report notes that, in addition to succeeding in a highly-competitive business, taxpayer was able to open three new locations in 1987 and that many of the large start-up expenses were paid for in cash, rather than using bank loans. The auditor's opinion was that

[t]he many discrepancies revealed as a result of an exhaustive but necessary investigation process cannot be explained away as mere ignorance of the law or lack of bookkeeping skills. Pervasive evidence has clearly demonstrated that [taxpayer] has committed fraudulent acts to avoid payment of taxes.

As a result, the auditor recommended that the statutory 50% evasion penalty be assessed in this case. Upon further review, the penalty was assessed on the underreported sales portion of the audit as well as on the purchases of capital assets in which no sales tax was paid and on those for which no tax was paid because the resale certificate was used.

#### DISCUSSION:

[1] The legislature has dictated that persons engaging in business in this state are taxable on the "gross proceeds" of the business. RCW 82.04. Additionally, persons selling taxable items are required to collect retail sales tax from their customers and remit such amounts to the Department of

Revenue. RCW 82.08.020. The buyer is legally obligated to pay the tax, and the seller is legally obligated to collect it. RCW 82.08.050. That statute further states that

[t]he amount of tax, until paid by the buyer to the seller or to the department, shall constitute a debt from the buyer to the seller and any seller who fails or refuses to collect the tax as required with intent to violate the provisions of this chapter or to gain some advantage or benefit, either direct or indirect, and any buyer who refuses to pay any tax due under this chapter shall be guilty of a misdemeanor.

Finally, the legislature has enacted RCW 82.32.070, which states that

[e]very person liable for any fee or tax imposed by chapters 82.04 through 82.27 RCW shall keep and preserve, for a period of five years, suitable records as may be necessary to determine the amount of any tax for which he may be liable, which records shall include copies of all federal income tax and state tax returns and reports made by him. All his books, records, and invoices shall be open for examination at any time by the department of revenue.

Any person who fails to comply with the requirements of this section shall be forever barred from questioning, in any court action or proceedings, the correctness of any assessment of taxes made by the department of revenue based upon any period for which such books, records, and invoices have not been so kept and preserved. (Emphasis supplied.)

The legislature's use of the word "shall" makes mandatory the requirement that taxpayers maintain records from which tax liability can be ascertained. The representative used by taxpayer to prepare her petition complains therein that the statute only "specifically" requires federal and state tax returns and reports made by the taxpayer. This contention is clearly incorrect. Such documents are included in the statutory requirement but are, by no means, the only documents required to support a claim that taxes have not been properly assessed.

Lacking adequate daily records from which to determine accurate sales, the auditor conducted interviews with all of taxpayer's landlords as well as personal observations of each location's business. She observed the number of customers during each observation period, the average charge per customer, that sales were rung up and that the taxpayer received payments for food which included collections of sales tax. From the observations, extrapolations of monthly and annual sales were made. The amounts were adjusted for periods during which the businesses were closed or for start-up periods, in the cases of [locations #3, #4, and #5]. Additionally, the auditor conducted another round of observations after the audit was completed, and some adjustments were made as a result of the second observation.

The audit could and would be easily adjusted if the taxpayer produced true and accurate records of its business. Records in the form of sheets in a spiral notebook on which a month and sometimes a year are written at the top and numbers are written next to what are purportedly dates are patently unacceptable as true and accurate daily records of the restaurant's operations. There is no way whatever of telling when each sheet was provided. There is no proof of date of preparation, no indication of the identity of the person making the entry, and no evidence proving that the number written on each line reflects sales--or, in this case, that the number is even a dollar amount, since no dollar signs were used. In the face of receipts admittedly manufactured as evidence of payment of tax, there is ample reason to doubt the veracity of the spiral notebook.

We find, consequently, that the auditor made a considerable effort to obtain any information on which to base a determination of the restaurants' sales. The taxpayer made obtaining accurate information directly impossible; as a result, the auditor was forced to use outside sources for information. This taxpayer was sufficiently sophisticated to lawfully and correctly register her business with the Department of Revenue at the outset, to charge and collect sales tax, and to file required tax forms showing at least some business activity over the years. She cannot, convincingly, contend that she did not know how to obtain information as to what aspects of her business were taxable and as to what her legal responsibilities are. Failure to keep and produce adequate records to support her claim that she properly reported income, taxes due and sales tax paid taxes and paid not only bars her from questioning the assessment, it, along with taxpayer's other behavior, is

convincing evidence of an intent to evade payment of tax. This failure was also the reason that the auditor was forced to contact landlords, fair organizers and the purveyor mentioned previously and to conduct on-site observations of the restaurants. Further, a claim that she did not know that conducting the exact same activity at a fair was taxable when she knows that the activity, if conducted in her restaurants, was taxable is simply without merit.

We find that the auditor has sufficiently documented the nature, volume and conditions of taxpayer's operations to show clearly that taxpayer not only underreported her sales but that she did so knowingly.

[2] The legislature has also enacted RCW 82.12, which requires that persons purchasing taxable items without paying retail sales tax are liable for payment of use tax or deferred sales tax. Only persons enjoying the benefit of a statutory exemption from taxability and persons lawfully using resale certificates are relieved of liability for payment of sales or use tax.

WAC 458-20-102 (Rule 102), which addresses the use of resale certificates, states that

[a]ny purchaser who fraudulently signs a resale certificate with intent to avoid payment of tax is guilty of a gross misdemeanor. When any resale certificate is found to have been fraudulently tendered to any seller or given under false or knowingly misleading circumstances, any retail sales tax which should have been paid but for the tendering of the certificate, which is assessed against the buyer, will automatically incur an evasion penalty of fifty percent of the tax found to be due.

The auditor found proof that taxpayer had made purchases of restaurant equipment. On the invoice copies, no tax was charged; the copies noted that a resale certificate was used. Taxpayer is in the restaurant business, not in the business of selling restaurant equipment. Use of the resale certificate was improper at the outset, and the continued use of the tax benefit over the four-year period for which the receipts are available is sufficient evidence not only of the improper use but of awareness that she was buying items without paying tax. As was stated previously, this taxpayer has consistently shown that she is sophisticated and more than capable of

successfully running her business. She cannot, now, expect to be believed when she makes unsubstantiated claims of not knowing how the resale certificate originally came into use. Additionally, she cannot, now, expect to have her claims of having paid tax on the purchases when the file contains copies of actual receipts along with receipts which bear the same numbers and have admittedly been fabricated either by taxpayer or by the unidentified person claimed to have suggested the idea to her and to have performed the actual fabrication.

Taxpayer's petition with regard to this portion of the assessment is denied. It is noted that, when true and accurate receipts were produced, the audit was adjusted to reflect that sales tax was paid on those items. Should further true and accurate receipts be submitted within the statutory period for requesting a correction of assessment, the taxpayer would, again, receive the benefit of reduction of the assessed amount.

[3] Taxpayer complains that her actions are not sufficient to constitute fraud, because she never intended to "cheat" on her taxes.

The Department assessed the 50 percent penalty under authority of RCW 82.32.050, which reads as follows, in pertinent part:

If the department finds that all or any part of the deficiency resulted from an intent to evade the tax payable hereunder, a further penalty of fifty percent of the additional tax found to be due shall be added.

Our task, then, is to decide whether the evidence is sufficient to sustain a finding that the taxpayer intended to evade payment of Washington business and occupation tax, retail sales tax and/or use tax. We are not guided by any appellate court decisions on point. There have been, however, many appeals to the Department concerning this issue. By administrative rule (WAC 458-20-100(12)) we are directed to:

. . . make such determination as may appear to [the Administrative Law Judge] just and lawful and in accordance with the rules, principles and precedents established by the department of revenue . . .

Prior Department Determinations establish the following principles in cases involving a claim of tax evasion:

1. The purpose of the statute is to allow the Department to exercise its discretion where it has found facts sufficient to penalize a taxpayer for activity which is a gross deviation from the spirit of our tax laws.
2. Merely failing to meet one's tax obligations is not the same as intention to evade the tax.
3. Tax avoidance is legal; tax evasion is not.
4. To sustain a 50 percent penalty assessment, the Department must find that the taxpayer intentionally acted to avoid paying the tax with the knowledge or belief that he or she in fact owed it. Put another way, the word "intent" presupposes knowledge.
5. Intent may be inferred from a taxpayer's conduct; that is, an inference of intent to evade can arise solely from the facts of the case. The taxpayer, once such an inference is established, then shoulders the burden of rebutting that inference.
6. Finally, and in summary, when a taxpayer is faced with a known tax obligation, commits an affirmative act such as signing a false statement, and the affirmative act was motivated by an intent to avoid the tax, the penalty will be sustained.

Det. No. 87-109, 2 WTD 463 (1987).

Applying the above guidelines to this case, we conclude that the facts do support a finding that the taxpayer knowingly engaged in activities which resulted in tax evasion. She clearly knew how and where to register her business with the state, indicating that she was aware that she must follow certain procedures if she chose to enjoy the benefits of operating a business in this state.

She contends that she didn't know that sales made in the fair locations were taxable, but she clearly knew that such sales were taxable at the restaurant locations. She violated sections of RCW 82.04 by failing to pay tax on the full amount of her sales, and she violated RCW 82.08.050 by collecting and not remitting retail sales tax on the underreported sales. Further, she violated 82.32.070 by failing to keep and preserve accurate records.

She violated RCW 82.04.470 by giving a resale certificate for equipment, knowing that the equipment was for use in her business and not for resale. She knew or should have known that she was required to pay sales tax on purchases that were not for resale in the course of her business, but she permitted the equipment purveyor to sell equipment to her over time in reliance upon the resale certificate which was improperly tendered at the outset and improperly, continuously used for years. She admittedly falsified receipts when questioned by the auditor; whether she actually lifted the pen or not is immaterial in light of her admission that she knew that the falsification occurred and that she submitted the falsified documents.

Because the tax, as assessed, has been painstakingly ascertained by the auditor and has not been contested with any documentation by the taxpayer, we must uphold the proper assessment of the tax. While we are in sympathy with the difficulties encountered by a small business in the daily effort to survive in the competitive marketplace, we are without authority to waive the evasion penalty in the face of such overwhelming evidence of intent to avoid paying tax on the part of this taxpayer. We note that the penalty was only assessed on the portions of the assessment regarding the underreported sales from the restaurants and fairs and only the portions regarding the falsified sales receipts and use of the resale certificate.

DECISION AND DISPOSITION:

Taxpayer's petition is denied.

DATED this 27th day of January 1989.