

Cite as Det. No. 17-0314, 42 WTD 049 (2023)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

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| In the Matter of the Petition for Correction of) | <u>D E T E R M I N A T I O N</u> |
| Assessment of) | |
|) | No. 17-0314 |
|) | |
| ...) | Registration No. . . . |
|) | |

[1] RCW 82.32.100: ESTIMATED ASSESSMENT – METHODOLOGY. The Department is open to employ whichever methodology it deems best and is not bound to only those methodologies sustained in published determination. Taxpayer’s point of sale system records are unreliable; because we doubt the accuracy of these records, we will not use these records to form a reasonable estimate of Taxpayer’s cash sales. Throughout six visits to Taxpayer’s restaurant, during the lunch hour, mid-day, and dinner hour, spread over several months, Audit observed and tracked how customers paid for meals. These visits resulted in a randomized and comprehensive sample of customer payment type. Audit averaged the remaining percentages to calculate a cash payments percentage of 45%. Audit met the statutory standard in RCW 82.32.100 by proceeding in the manner that it deemed best to obtain facts and information on which to base its estimate of tax, and Taxpayer has failed to persuade us that the method employed by Audit produced an unreasonable estimate.

[2] RCW 82.32.090; WAC 458-20-228: PENALTIES – EVASION. Where Taxpayer hired a bookkeeper to report and pay taxes to the Department and had a history of reporting business income under the correct B&O tax classification (retailing) and charging its customers retail sales tax at the correct rate, this is clear, cogent, and convincing evidence that Taxpayer had knowledge of its B&O tax liability and retail sales tax liability.

Where Taxpayer collected retail sales tax from customers at the correct rate; entered cash purchases into Taxpayer’s POS system; provided customers with receipts for such purchases; and then provided the Department with business records that did not correctly show a majority of the cash purchases that Taxpayer entered into its POS system - without explanation as to why the cash purchases entered into the POS system did not appear in business records or appeared for an altered amount – these outward manifestations are clear, cogent, and convincing evidence that Taxpayer undertook an intentional act of removing or reducing purchases from business records to escape detection and payment of taxes with respect to the removed or reduced amount transactions.

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.

Anderson, T.R.O. – A restaurant disputes an estimated percentage of cash sales (and the resulting tax assessment) and an assessment of the evasion penalty. The restaurant asserts that the Department erred in estimating based on multiple observations of cash and credit or debit card sales entered into the point-of-sale system and should have based its estimate on industry averages. The restaurant also asserts the Department has not shown that it intended to evade paying taxes. Petition denied.¹

ISSUES

1. Under RCW 82.32.100, did the Department calculate a reasonable estimate of the percentage of cash sales by observing, on multiple occasions, the number of cash and credit or debit card sales entered into the point-of-sale system?
2. Under RCW 82.32.090 and WAC 458-20-228, did the Department show a restaurant intended to evade payment of retailing business and occupation tax and retail sales tax, where the restaurant's books and records only showed one out of five Department purchases?

FINDINGS OF FACT

. . . (“Taxpayer”) operates a Japanese cuisine restaurant featuring sushi in . . . , Washington. Customers sit at a sushi conveyor belt or in a booth and order food from a server. Taxpayer charges between \$. . . and \$. . . for its most popular sushi plates. Once customers finish their meals, a server provides a hand-written ticket itemizing the number and types of plates of food consumed. Then, customers take the tickets to the cashier at the front of the restaurant to pay for their meals.

Taxpayer uses an electronic point of sale system to record sales and payment. The system is located in the front of the restaurant and includes a cash drawer, computer and monitor, receipt printer, and payment card reader. Taxpayer uses the computer software . . . to operate the point-of-sale system.

The Department's Audit Division (“Audit”) reviewed Taxpayer's books and records from January 1, 2012, through March 31, 2016 (the “Audit Period”). Eventually, for reasons explained below, Audit concluded that Taxpayer's books and records were unreliable and estimated Taxpayer's retail sales during the Audit Period.

On October 28, 2016, Audit issued a \$. . . assessment against Taxpayer comprised of \$. . . in retail sales tax; \$. . . in retailing business and occupation (“B&O”) tax; \$. . . in use tax/deferred retail sales tax; a \$. . . B&O tax credit for syrup tax paid \$. . . in interest; \$. . . in evasion penalty; and \$. . . in assessment penalty. Taxpayer requests review of this assessment and raises two objections: first, Taxpayer disputes the method used to calculate an estimate of cash retail sales (and assess

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

retailing B&O tax and retail sales tax), and second, Taxpayer disputes the assessment of the evasion penalty.

Unreliability of Taxpayer’s Records

Audit visited Taxpayer’s restaurant on several occasions to observe restaurant operations. These visits occurred before and during its review of Taxpayer’s books and records; some of these visits were announced and some were not.

During five of the unannounced visits that occurred during the Audit Period, Audit purchased food and beverages from Taxpayer, paid for the items with cash, and received a receipt from Taxpayer’s electronic point-of-sale system. The following chart shows the Department purchases and Taxpayer’s record of these purchases:

| | Purchase Subtotal | Retail Sales Tax | Total Purchase Amount | Recorded Purchase Subtotal Amount | Unrecorded Purchase Subtotal Amount | Notes |
|--------------|--------------------------|-------------------------|------------------------------|--|--|--------------------|
| 12/21/2015 | \$... | \$... | \$... | - | \$... | Not found |
| 12/31/2015 | \$... | \$... | \$... | - | \$... | Not found |
| 1/20/2016 | \$... | \$... | \$... | \$... | \$... | Partially recorded |
| 1/23/2016 | \$... | \$... | \$... | \$... | \$... | Partially recorded |
| 1/27/2016 | \$... | \$... | \$... | \$... | - | Correctly recorded |
| Total | \$... | \$... | \$... | \$... | \$... | |

Audit also observed the following during these visits and its review of Taxpayer’s books and records: [Unusual cash handling procedures; unusual volume of cash payments; and abnormal business operations costs; . . .]

Audit concluded that Taxpayer’s books and records were unreliable based on these observations. Taxpayer does not dispute this conclusion.

Because Audit concluded that Taxpayer’s books and records were unreliable, Audit calculated an estimate of Taxpayer’s retail sales during the Audit Period. Audit’s estimate of total retail sales is comprised of estimated credit or debit card payments and estimated cash payments.

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To estimate cash payments, Audit relied upon several observations of the frequency at which Taxpayer's customers paid in cash. During six visits to Taxpayer's restaurant, Audit observed and tracked the number of cash and credit/debit card payments, as follows:

| Date | Visit Duration | Observed Cash Payments | Observed Credit/Debit Payments | Observed % Cash Payments |
|------------|-------------------|------------------------|--------------------------------|--------------------------|
| 12/31/2015 | 3:45pm – 4:15pm | 3 | 10 | 23% |
| 1/20/2016 | 12:00pm – 1:00pm | 7 | 6 | 54% |
| 1/23/2016 | 12:15pm – 2:00pm | 4 | 4 | 50% |
| 1/27/2016 | 2:00pm – 3:00pm | 16 | 9 | 64% |
| 5/27/2016 | 11:25am – 11:55am | 3 | 7 | 50% |
| 6/17/2016 | 4:45pm – 5:45pm | 5 | 5 | 50% |

Audit used these observations to calculate an average percentage of the frequency at which Taxpayer's customers paid in cash (relative to total payments). . . .

By using the credit/debit card payment data and observed (average) cash payment percentage, Audit was able to impute an estimate of cash retail sales. . . . Audit added the estimate of total cash retail sales to the verified total of credit and debit card retail sales and assessed retail sales tax and retailing B&O tax to the extent that this sum exceeded amounts reported by Taxpayer.

Taxpayer's Assertions

Taxpayer requests review of the assessment. Taxpayer does not dispute Audit's conclusion that its books and records are unreliable, and an estimate is necessary. Nor does Taxpayer dispute the methodology employed by Audit to calculate cash retail sales.

Rather, Taxpayer disputes Audit's estimated cash payment percentage of 45% (a component of the calculation) and asserts that it produces an unreasonable estimate of retail sales and assessed tax. Taxpayer raises the following concerns about the use of the observed cash payment percentage: (1) The observed cash payment percentage is much higher than industry averages and those used in prior Department Determinations – specifically, Dets. Nos. 05-0350, 35 WTD 291 (2014), 12-0136, 32 WTD 65 (2014), 13-0272, 33 WTD 70 (2014), and 13-0302R, 33 WTD 572 (2014); (2) The percentage was calculated without reference to the purchase amount; (3) The percentage ignores the well-known trend away from cash; and (4) The percentage was calculated based on a relatively small number of observations, under 10 hours of observations in total.

Instead, Taxpayer asserts that the Department should use a cash payment percentage of 22%, to calculate total retail sales. Taxpayer states that it calculated a cash payment percentage of 22% using 1,500 sales tickets from December 12, 2016, through December 18, 2016. In support, Taxpayer provides daily sales totals, calculations, and surveillance video from the restaurant behind the point-of-sale system. Taxpayer asserts that this percentage is more accurate than Audit's observed percentage of 45% because it is based on a larger number of transactions, over a longer period of time.

In response, Audit states that it previously found Taxpayer's records of cash transactions to be missing or modified in the point-of-sale system, and Audit is unwilling to accept the reliability of the additional records because it has no way to verify whether these records include cash transactions missing or modified in the same manner. Audit states that the surveillance video footage of the cash register does not provide any evidence of the reliability of the point-of-sale system because, "Many known electronic methods of sales suppression entail initially ringing items into the cash register, and then deleting or modifying the [point of sale system] at a later time, sometimes even remotely or from another terminal." Audit Response to Petition dated February 17, 2017.

Taxpayer also disputes the assessment of the evasion penalty on the basis that Audit has failed to show by clear, cogent, and convincing evidence that Taxpayer intended to evade the payment of tax during the Audit Period.

ANALYSIS

Estimate

RCW 82.32.070 provides:

(1) Every taxpayer liable for any tax collected by the department must keep and preserve, for a period of five years, suitable records as may be necessary to determine the amount of any tax for which the taxpayer may be liable. Such records must include copies of all of the taxpayer's federal income tax and state tax returns and reports. All of the taxpayer's books, records, and invoices must be open for examination at any time by the department of revenue.

RCW 82.32.070(1). The Department explains in WAC 458-20-254 (the Department's administrative rule applying the statutory recordkeeping requirement) that these records must demonstrate the amounts of: (i) gross receipts and sales from all sources; (ii) deductions, exemptions, or credits claimed; (iii) payments of retail sales tax or use tax; and (iv) refunds claimed. WAC 458-20-254(3)(b).^[2]

Taxpayer did not keep suitable records of sales. Out of five Department cash purchases, two were missing completely, two appeared for a modified amount, and only one accurately appeared in Taxpayer's business records. The records that Taxpayer did keep show financial information inconsistent with restaurant industry financial benchmarks and ratios. Audit struggled to understand how Taxpayer could continue to operate with such a high cost of goods sold (expressed as a percentage of recorded sales). In addition, Taxpayer employed an unusual practice of recording those business expenses paid for with cash, once a year, instead of contemporaneous to the purchases, and Taxpayer never made a cash deposit during the Audit Period. These circumstances led Audit, and lead us, to conclude that Taxpayer's records were not suitable in accordance with RCW 82.32.070.

² [The Department made formatting changes to Rule 254 in 2020, including subsection renumbering. Wash. St. Reg. 20-22-093, filed November 3, 2020 (effective December 4, 2020).]

If a person fails to keep and preserve suitable records, then RCW 82.32.100 provides:

- (1) If any person fails or refuses to make any return or to make available for examination the records required by this chapter, the department shall proceed, in such manner as it may deem best, to obtain facts and information on which to base its estimate of tax; and to this end the department may examine the records of any such person as provided in RCW 82.32.110.

RCW 82.32.100(1). This statutory provision affords the Department wide discretion in the methodology employed to calculate a reasonable estimate of tax. *See, Id.*; Det. No. 15-0350, 35 WTD 291 (2015) (“We have previously noted and affirmed the Department’s authority to assess taxes based on a reasonable estimate. *See* Det. No. 14-0106, 33 WTD 402 (2014); Det. No. 13-0302R, 33 WTD 572 (2014); Det. No. 03-0279, 23 WTD (2004); Det. No. 97-134R, 18 WTD 163 (1999)”).

The Department employs a broad range of methodologies in estimating tax liability. Published determinations show the Department using the following to estimate gross income: industry studies, bank statements, Federal income tax records, records of employee wages, purchase records, and statistical and block sampling. Det. No. 15-0350, 35 WTD 291 (2016) (estimate of cash sales based on industry study on payment methods); Det. No. 16-0218, 36 WTD 063 (2017) (estimate of income based on bank statements); Det. No. 15-0148, 35 WTD 10 (2016) (estimate of unreported income and sales and use tax based on Federal income tax apportionment schedules and trial balance reports); Det. No. 15-0026, 34 WTD 373 (2015) (estimate of income and uncollected retail sales tax based on records of wages of workers); Det. No. 11-0346, 32 WTD 60 (2013) (estimate of retail sales tax based on purchase records); Det. No. 10-0386, 32 WTD 81, 91 - 92 (2013) (discussing Department’s use of statistical sampling and block sampling).

Specifically, for restaurants, published determinations show the Department employing the following two methodologies to estimate cash sales: (1) Substituting a percentage of cash sales based on industry studies on customer payment practices; and (2) calculating a percentage of cash sales based on point-of-sale system voids where numbered meals tickets were missing, and the auditor observed two out of five customers paid in cash. 35 WTD 291; Det. No. 13-0272, 33 WTD 70 (2014); Det. No. 12-0201, 32 WTD 151 (2013); Det. No. 12-0136, 32 WTD 65 (2013); Det. No. 13-0302R, 33 WTD 572 (2014).

Here, Audit employed an estimation of cash sales method based on averaging several observations of customer payment methods. Taxpayer asserts that we should substitute an industry average of 22% cash sales because Audit’s method produces an unreasonable estimate, for the following reasons: (1) Based on observations made during a relatively brief period of time; (2) result falls outside comparable industry benchmark or average; (3) result is higher than estimates used in all published determinations; (4) method has not been sustained in published determination; (5) assumes all cash sales are for the same average amount as all non-cash sales; and (6) ignores trend away from cash. Ultimately, as explained below, Taxpayer’s assertions do not persuade us.

As noted above, RCW 82.32.100 affords the Department broad discretion in estimating tax. The Department is open to employ whichever methodology it deems best and is not bound to only

those methodologies sustained in published determination. Similarly, the Department is not limited to an estimate amount sustained in published determinations.

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Taxpayer's business records contained several anomalies. Sales were missing without explanation[,] and business expenses were much higher than industry averages. Not to mention that Taxpayer did not make a single cash deposit during the Audit Period and employed an unusual business practice of recording cash expenses annually, a practice that could have resulted in erroneous understatement of business expenses (meaning, the business expenses could have accounted for an even greater percentage of reported sales). These unexplained anomalies indicate that Taxpayer's business was not an average business[,] because the data did not correspond to any business benchmarks and led Audit to conclude that using industry averages to estimate cash sales was not best because it would produce an inaccurate estimate.

Instead, Audit determined that it would need to estimate cash retail sales based on the limited reliable business information available. Audit had reliable records of the amounts of credit/debit card retail sales from [federal income tax records] but no records of cash retail sales. . . . Mathematically, this calculation required a percentage of the frequency at which Taxpayer's customers paid with cash.

No reliable records or data existed that would allow the calculation of this percentage. Audit [chose to estimate] the cash payments percentage . . . by observing how customers actually paid. Throughout six visits to Taxpayer's restaurant, during the lunch hour, mid-day, and dinner hour, spread over several months, Audit observed and tracked how customers paid for meals. These visits resulted in a randomized and comprehensive sample of customer payment type. Audit averaged the remaining percentages to calculate a cash payments percentage of 45%.

Taxpayer assigns error to Audit's sampling because the observations were made during a brief period of time; the percentage does not take into account the sales amounts and the likelihood that cash payment decreases with an increase in amount; and ignores the payment trend away from cash. Taxpayer asks us to substitute its data that allegedly indicates a cash sales percentage of 22%. Above, we conclude that Taxpayer's point of sale system records are unreliable; because we doubt the accuracy of these records, we will not use these records to form a reasonable estimate of Taxpayer's cash sales.

There is truth to Taxpayer's assertion about Audit's method not taking into account sales amounts, but the same issue would also be present if Audit substituted Taxpayer's percentage. Taxpayer's conjecture does not make Audit's estimate of Taxpayer's cash sales percentage unreasonable.

Further, as to Audit's method not recognizing a payment trend away from cash over time, we find the opposite to be true. Audit made observations at the end of and after the close of, the Audit Period and projected back in time over the Audit Period. Meaning, Taxpayer got the benefit of the decreased 2016 cash payment percentage for years in which the cash payment percentage was higher than 2016 – 2013, 2014, and 2015 – according to the trend cited by Taxpayer.

We sustain the estimated assessment. Audit met the statutory standard in RCW 82.32.100 by proceeding in the manner that it deemed best to obtain facts and information on which to base its estimate of tax[,] and Taxpayer has failed to persuade us that the method employed by Audit produced an unreasonable estimate.

Evasion Penalty

RCW 82.32.090 requires the Department to assess an evasion penalty in certain circumstances and reads, “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 must be added.” RCW 82.32.090(7).

WAC 458-20-228 is the Department’s administrative rule that explains and illustrates the application of the evasion penalty. It reads in pertinent part as follows:

The evasion penalty is imposed when a taxpayer knows a tax liability is due but attempts to escape detection or payment of the tax liability through deceit, fraud, or other intentional wrongdoing. An intent to evade does not exist where a deficiency is the result of an honest mistake, miscommunication, or the lack of knowledge regarding proper accounting methods. The department has the burden of showing the existence of an intent to evade a tax liability through clear, cogent and convincing evidence.

WAC 458-20-228(5)(f). Thus, there are two elements to establishing an “intent to evade”: (1) knowledge of a tax liability; and (2) an intentional act to escape detection or payment. *Id.*; *see also* Det. No. 13-0329, 33 WTD 156 (2014). Clear, cogent, and convincing evidence has been described as evidence convincing the trier of fact that the issue is “highly probable,” or, stated another way, the evidence must be “positive and unequivocal.” *Colonial Imports, Inc. v. Carlton Northwest, Inc.*, 121 Wn.2d 726, 735, 853 P.2d 913 (1993).

Here, Taxpayer hired a bookkeeper to report and pay taxes to the Department. Taxpayer had a history of reporting business income under the correct, retailing B&O tax classification. Taxpayer also had a history of charging its customers retail sales tax at the correct rate. We conclude that this tax reporting/charging history is clear, cogent, and convincing evidence that Taxpayer had knowledge of its B&O tax liability and retail sales tax liability.

Regarding intent, the Washington State Supreme Court has stated:

The intent with which an act is done is a mental process, and as such generally remains hidden within the mind where it is conceived, and is rarely, if ever, susceptible of proof by direct evidence. However, intent may be inferred or gathered from the outward manifestations, by the words or acts of the person entertaining it, and the facts and circumstances surrounding [the alleged offense].

State v. Gaul, 88 Wash. 295, 301, 152 P. 1029, 1032 (1915). Here, Taxpayer’s outward manifestations were: (1) collecting retail sales tax from customers at the correct rate; (2) entering

cash purchases into Taxpayer's POS system and providing customers receipts for such purchases; and (3) providing the Department with business records that do not correctly show a majority of the cash purchases that Taxpayer entered into its POS system. Taxpayer offers no explanation as to why the cash purchases entered into the POS system did not appear in business records or appeared for an altered amount.

Taxpayer's bookkeeper stated that she would report and pay taxes to the Department based on the amounts listed in Taxpayer's business records. The effects of Taxpayer's outward manifestations were to reduce Taxpayer's B&O tax liability and retail sales tax liability because the business records reflected a lower amount of reported sales. The effect of Taxpayer's outward manifestations also produced a windfall for Taxpayer in the amounts of retail sales tax collected but not remitted because the business records did not report such sales.

We conclude that Taxpayer's outward manifestations are clear, cogent, and convincing evidence that Taxpayer undertook an intentional act of removing or reducing purchases from business records to escape detection and payment of taxes with respect to the removed or reduced amount transactions. Accordingly, we conclude that the Department has shown Taxpayer intended to evade payment of retailing B&O taxes and retail sales tax. *See* WAC 458-20-228(5)(f)(ii)(B)(The willful failure of a seller to remit retail sales taxes collected from customers to the Department is generally considered an action that establishes an intent to evade a tax liability).

Once the Department has clearly established the elements of evasion, a burden of production is imposed on the taxpayer to produce evidence of honest mistake, miscommunication, ignorance of law, lack of knowledge, or some other fact that tends to rebut the Department's evidence. Det. No. 16-0066, 35 WTD 540 (2016). Taxpayer has offered no such evidence or even an explanation for the reason transactions were missing from its business records or appeared for a reduced amount. Accordingly, we sustain the assessments of evasion penalties.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 28th day of December 2017.