

Cite as Det. No. 14-0156, 34 WTD 196 (2015)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Refund of)	<u>D E T E R M I N A T I O N</u>
)	
)	No. 14-0156
...)	
)	Registration No. . . .
)	

[1] RCW 82.32.060(1) – PERIOD OF LIMITATIONS – PAYMENT – NET CREDIT: A net credit adjustment, resulting from a multi-year audit - with debit and credit adjustments, is not a payment of taxes, penalties, or interest, by a taxpayer, for purposes of the nonclaim period in RCW 82.32.060(1).

[2] RCW 82.32.100; 22 WTD 174 – AUDIT – BLOCK SAMPLE - DISAGREEMENT: Where a taxpayer disagrees with the result of a block sample, the only remedy on appeal is a remand for actual review of all records, and, should a taxpayer fail to provide sufficient records for actual review, the assessment based on the block sample shall be sustained pursuant to RCW 82.32.100.

[3] RCW 82.04.460; WAC 458-20-194(4)(g) – APPORTIONMENT – THIRD PARTY COSTS: Taxpayer has the burden to demonstrate that a “representative third party” directly provides services to a taxpayer’s customers, and, in the absence of such proof, its panelists’ costs were properly classified as “other costs” for purposes of the apportionment ratio in WAC 458-20-194.

[4] RCW 82.32.060; WAC 458-20-229(3)(b) – REFUND REQUEST - SUBSTANTIATION: Where a taxpayer made a refund request, the Department determined it was lacking adequate substantiation to process the refund request and provided a taxpayer with written request and 90 days to produce such substantiation, and the taxpayer failed to provide the substantiation necessary to support the refund request, the Department shall deny the refund request for lack of adequate substantiation.

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, A.L.J. – An internet marketing research company challenges Audit’s denial of its several applications for refund, on the basis that the nonclaim period had not run on some claims, that unusual items in a non-statistical block sample should be excluded from the sample, that panelist costs should be treated as representative third party costs, and two refund requests were improperly denied for lack of substantiation. Petition denied.¹

ISSUES

1. In a multi-year audit, with debit and credit adjustments, resulting in a net credit adjustment, is the credit adjustment a payment by taxpayer to the Department, pursuant to RCW 82.32.060(1) such that the nonclaim period has not run?
2. When an audit is based on a block sample, can a taxpayer require extraordinary items to be removed from the block or is the option to have an audit done of actual records for the audit period?
3. In apportioning income, are amounts paid by Taxpayer to panelists and brokers, representative third party costs pursuant to WAC 458-20-194?
4. Pursuant to RCW 82.32.100 and WAC 45-20-229, did taxpayer provide sufficient documentation to substantiate its refund requests for the fourth quarter of 2007 and 2008?

FINDINGS OF FACT

[Taxpayer] operated an internet market research company until December 31, 2013. It was headquartered in Washington . . . with affiliate companies, branch offices and/or employees throughout the United States and in Canada, United Kingdom, Netherlands, Norway, China, Germany, and Brazil.

Taxpayer creates custom surveys for customers, distributes the surveys to its worldwide panel, collects the results, and then passes on the information to its customers. Taxpayer makes payments to panelists and brokers who solicit panelists. Taxpayer will pass on accumulated raw data from panelist surveys to customers, but panelists do not directly provide feedback to customers.

Customers may access internally developed software but not take possession. Taxpayer typically receives the following types of monthly revenues for services provided to customers: (1) fees for obtaining access to the company’s hosted software; (2) amortization of related set up fees; (3) panel related fees recognized in the period the customer’s survey is substantially completed; and (4) service fees from data management questionnaire design and foreign language translation fees.

This appeal concerns Audit’s denial of several refund applications filed by the Taxpayer covering several tax periods. These are the periods at issue: audit period, subsequent period, and

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

2008. The issues are nonclaim period, apportionment (block sampling and representative third party costs), and failure to substantiate refund requests.

January 1, 2004 – September 30, 2007 (Audit Period)

The Washington State Department of Revenue's (the "Department's") Audit Division ("Audit") examined Taxpayer's books and records for the period of January 1, 2004, to September 30, 2007 (the "Audit Period"). On January 29, 2009, it issued Taxpayer a credit assessment in the amount of \$. . . , consisting of a debit adjustment of \$. . . for 2004, debit adjustment of \$. . . for 2005, credit adjustment of \$. . . for 2006, and credit adjustment of \$. . . for 2007.

In a letter dated December 27, 2010, Taxpayer requested a refund of \$. . . of service and other activities business and occupation ("B&O") tax and retail sales and use tax, for the period of January 1, 2006 through December 31, 2006. In a letter dated July 22, 2011, Taxpayer submitted another refund request for the entire Audit Period, January 1, 2004 through September 30, 2007, and raised the refund request amount to \$. . . (\$. . . in service and other B&O tax and \$. . . in retail sales and use tax).

Taxpayer's refund request for service and other activities B&O tax raised challenges to the calculation of its apportionment ratio.² Taxpayer also requested a refund of retail sales tax paid to vendors on purchases of fixed assets and consumables during the Audit Period that Taxpayer now asserts were exempt.

Audit reviewed Taxpayer's refund request and requested additional information from Taxpayer about its challenges to the calculation of its apportionment ratio, on January 25, 2012, August 23, 2012, and December 4, 2012.³ On April 17, 2013, Audit refunded Taxpayer \$. . . , consisting of \$. . . in use tax/deferred retail sales tax and \$. . . in interest, and denied the remainder of Taxpayer's refund request. Audit found that Taxpayer's refund request for taxes with respect to 2004 and 2005 untimely because Taxpayer asked for a refund of taxes more than four years

² Taxpayer raised the following three challenges: : (1) [Customer A] sales should be reviewed on an actual basis because there was an unusually high amount of sales in 2006 due to a business acquisition in August 2005; (2) Direct Panelist Expenses and Panelist Costs were inappropriately classified as Other Costs and should have been classified as Representative 3rd Party Costs; and (3) Only sales with nexus were used to determine the Washington percentage of other costs and all sales should have been used.

³ Audit's December 4, 2012 request asks for the following information:

- General ledger and/or transaction summaries for 2007 (electronic format)
- General and/or adjusting journals for 2007 (electronic format)
- Payroll detail for 2007 (electronic format)
- A list of real property owned or leased at the end of 2007 and its location (electronic format)
- Leasing costs for Washington property for 2007
- Depreciation costs for Washington property for 2007
- Supporting documentation for any change in nexus for sales from September to December 2007
- Corporate officers salaries for 2007 broken out by each corporate officer (provided there was no change to the corporate officers identified in the prior audit)
- Listing of 2007 contractors identified as third party representatives, each contractors earnings, the location of each contractor, and a description of the contracted work required by the representative.
- A copy of the taxpayer's 2007 Federal Income Tax Return with any workpapers used to allocate costs or income between states where the taxpayer has nexus.

following the close of the tax year in which payment occurred. Audit determined that Taxpayer had provided insufficient information about its challenges to the calculation of its apportionment ratio and denied that portion of the refund request.

Taxpayer appeals the denied portion of the refund request. For 2004 and 2005, it asserts that it made a payment for 2004 and 2005 at the conclusion of the audit in January 2009 (when the credit adjustment was issued), and cites 3 WTD 435 in support of its assertion that the netting/consolidation does not change the underlying nature of each separate year and payments were due for 2004 and 2005. In addition, Taxpayer asserts that “RCW 82.32.060 clearly states that a refund request be made within four years prior to the beginning of the calendar year in which the refund application is made or examination of records is completed.

For the apportionment ratio calculation, Taxpayer raises two challenges. First, Taxpayer disputes the 2006 block sample. Audit and Taxpayer agreed to conduct a block sample to calculate Taxpayer’s income apportionment ratio for the Audit Period and selected the period of 2006. Taxpayer does not dispute that it agreed to the 2006 block sample. However, after receiving the results of the block sample, Taxpayer requested Audit remove the [Customer A] sales from the block sample and examine such sales on an actual basis because such sales were extraordinary items in 2006.⁴ Audit was unwilling to remove [Customer A] sales from the block sample and still use the block sample, but offered to actually examine Taxpayer’s records for the Audit Period.

Taxpayer asserts that Audit’s offer to perform an actual examination of the Audit Period is unnecessary and Audit did not follow proper procedure because the statistical sampling manual allegedly provides that Audit should keep the non-statistical sampling block and remove the extraordinary items. In support, Taxpayer cites to an “Audit Division Sampling Policy, Effective September 1, 2002,” which states in part:

Agreement of Sample. When you plan to use a sample, it is important that the taxpayer agrees with the sampling method before you begin. Therefore, it is recommended that you discuss the methods of sampling with the taxpayer and discuss how the sample will be used. You also want to agree, in advance, how extraordinary items (rare or unusual items in the sample or population) will be managed.

Second, Taxpayer disputes Audit’s classification of “Direct Panelist Expenses” and “Panelist Costs” (collectively, “panelist expenses”) as other costs and asserts the panelist expenses are “representative third party” costs pursuant to WAC 458-20-194(4)(g)(i). Taxpayer argues the panelist expenses are third party costs because the panelists are providing services on its behalf in completing surveys and providing feedback to its customers and these services are provided directly to its customers because it forwards raw data from panelists to customers. Audit determined such services were not directly provided from panelists to customers because Taxpayer transmits panelists’ responses to provide strict panelist privacy and client confidentiality.

⁴ Taxpayer asserts in 2006, [Customer A] sales were \$. . . of \$. . . in total Washington sales for the year, and [Customer A] sales were \$. . . in 2005 and \$. . . from January 1 – September 30, 2007.

October 1 – December 31, 2007 (“4th Quarter 2007 Refund Request”)

In a letter dated December 20, 2011, Taxpayer requested a refund of \$. . . in service and other activities B&O tax paid to the Department from October 1 – December 31, 2007 (4th Quarter 2007). On March 28, 2013, Taxpayer amended the amount of the 4th Quarter 2007 Refund Request to either, \$. . . based on calculations using a 23% apportionment ratio or \$. . . based on calculations using a 30% apportionment ratio. On April 15, 2013, Audit denied this refund request because Taxpayer had failed to provide requested records to substantiate the request.

Audit applied the 2006 block sample apportionment percentage to 4th Quarter 2007. For reasons explained above, Taxpayer disagrees with the 2006 block sample apportionment ratio and includes the 4th Quarter 2007 Refund Request in this appeal because it has appealed the 2006 block sample. Taxpayer asserts the auditor stated that the apportionment ratio for the 4th Quarter 2007 would be the apportionment ratio determined for January 1 – September 30, 2007.

January 1 – December 31, 2008 (“2008 Refund Request”)

In a letter dated December 31, 2008, Taxpayer requested a refund of \$. . . in service and other activities B&O tax paid to the Department from January 1 – December 31, 2008. On July 19, 2013, Audit denied Taxpayer’s 2008 Refund Request because Taxpayer did not produce the documents that Audit requested to substantiate the refund request.

Taxpayer states:

In addition a protective claim for 2008 was timely filed on December 31, 2012. We received a 90-day letter dated March 20, 2013 requesting detailed information be provided by June 19, 2013. Because the issues are the same as the issues included in this appeal we are including this period in the appeal petition and will not be providing the information requested until such time that we have had our appeal ruled on.

ANALYSIS

Non-Claim Limitations Period: 2004 & 2005

Refunds of taxes, penalties, and interest, paid to the Department, are governed by RCW 82.32.060. RCW 82.32.060 states:

(1) If, upon receipt of an application by a taxpayer for a refund or for an audit of the taxpayer’s records, or upon an examination of the returns or records of any taxpayer, it is determined by the department that within the statutory period for assessment of taxes, penalties, or interest prescribed by RCW 82.32.050 any amount of tax, penalty, or interest has been paid in excess of that properly due, the excess amount paid within, or attributable to, such period must be credited to the taxpayer’s account or must be refunded to the taxpayer, at the taxpayer’s option. Except as provided in subsection (2) of this section, no refund or credit may be made for taxes, penalties, or interest paid more

than four years prior to the beginning of the calendar year in which the refund application is made or examination of records is completed.

(2)(a) The execution of a written waiver under RCW 82.32.050 or 82.32.100 will extend the time for making a refund or credit of any taxes paid during, or attributable to, the years covered by the waiver if, prior to the expiration of the waiver period, an application for refund of such taxes is made by the taxpayer or the department discovers a refund or credit is due.

(Emphasis added.) RCW 82.32.050 is referenced in and to be read in conjunction with RCW 82.32.060. RCW 82.32.050 states:

(4) No assessment or correction of an assessment for additional taxes, penalties, or interest due may be made by the department more than four years after the close of the tax year, except (a) against a taxpayer who has not registered as required by this chapter, (b) upon a showing of fraud or of misrepresentation of a material fact by the taxpayer, or (c) where taxpayer has executed a written waiver of such limitation. The execution of a written waiver shall also extend the period for making a refund or credit as provided in RCW 82.32.060(2).

Applications for refund must be received by the Department within the statutory refund period. RCW 82.32.060. The statutory refund period is the statutory assessment period prescribed in RCW 82.32.050, RCW 82.32.060(1). Except in the case of a written waiver, a refund request must be received within of four years after the close of the tax year in which payment occurred. RCW 82.32.060(1), (2)(a); WAC 458-20-229(2)(a). And, the execution of a written waiver will only extend the time for timely refund requests to the waiver's date of expiration. RCW 82.32.060(2)(a).

Taxpayer asserts that the netting of tax underpayments (2004 and 2005) with the credits for overpayments (2006 and 2007) at the close of the audit, in January 2009, constitutes payments for 2004 and 2005 taxes assessed during the Audit Period. It is well established that "amount paid" in RCW 82.32.060 means an actual payment and the netting of offsetting debits and credits will not suffice. In Det. No. 02-002, 22 WTD 131 (2003), we considered whether a taxpayer had paid any taxes as a result of an assessment where the taxpayer was issued a credit assessment.⁵ We stated, "Because the audit resulted in a credit assessment, the taxpayer did not pay anything on the assessment." 22 WTD at 135. We concluded, "Any taxes, which could be credited or refunded, were paid on the taxpayer's combined excise tax returns. Therefore, the applicable statute of limitations is based upon the tax return payments and not on when the audit was completed or the assessment issued." 22 WTD 135-136. We found our decision in 22 WTD 131 supported by the Washington State Supreme Court's holding in *Paccar, Inc. v. Dep't of Revenue*, 135 Wn.2d 301 (1998), which concluded that RCW 82.32.060 requires actual payment and stated:

⁵ The term "credit assessment" is a term of art used by the Department when it audits the taxpayer's records and determines the taxpayer overpaid taxes. It is technically not an assessment because no additional taxes were found to be due.

Under RCW 82.32.060, a taxpayer may receive a refund of excess taxes paid upon a deficiency assessment calculated for a period prior to the statutory four-year period if the taxpayer files a petition for refund within four years of actual payment of the deficiency assessment.

Id., at 321.

The same holds true for Taxpayer. “. . . [A]mount paid within, or attributable to, such period . . .” in RCW 82.32.060 means an actual payment must have been made within four years prior to the beginning of the calendar year in which the refund request is made, and the netting of tax underpayments and overpayments, resulting in a credit assessment is not an actual payment. Therefore, we conclude that Taxpayer did not make an actual payment at the conclusion of the audit, in January 2009, and its refund request is untimely as to 2004 and 2005.

In addition, Taxpayer asserts that RCW 82.32.060(1) allows a refund request to be made within four years prior to the beginning of the calendar year in which the examination of records is completed. This ignores the payment requirement included in the plain language of RCW 82.32.060(1) and WAC 458-20-229(2). It is the date of payment that establishes the non-claim period for refunds and the date of conclusion of the examination of records is irrelevant here.

Block Sampling

The Department recognizes that a sampling of documents, rather than a review of all of the records for the entire period, and projecting the results over the entire period, is an accepted and commonly used auditing method to estimate the amount of tax underpaid or over paid. Det. No. 02-0114, 22 WTD 174, 177 (2003). The Department has often used test periods as a sampling method. *See, e.g.*, Det. No. 88-233, 6 WTD 59 (1988); Det. No. 87-354, 4 WTD 293 (1987); Det. No. 93-240, 13 WTD 369 (1994). Such methods are also known as block sampling. Other sampling methods, such as statistical sampling, may also be utilized to project a tax liability when all of the actual records are not available or it is impracticable or inefficient to simply rely on the entire collection of actual records.

In block sampling, the auditor chooses a group or block of transactions that took place during a specified time period or in a certain location. The selection of the block is usually not the result of a random process. Generally, the block that is selected is based on convenience and accessibility. *See* Jeri Mulrow, *Statistical Sampling as a Win-Win in Tax Audits*, 15 State Tax Notes 1491 (December 7, 1998). The Department has often used block sampling as a means to determine a taxpayer’s liability. *See* Det. No. 88-233, 6 WTD 59 (1988); Det. No. 87-354, 4 WTD 293 (1987); Det. No. 93-240, 13 WD 269 (1994).

In general, a taxpayer’s choice is to accept a block sample or request an actual review of records. Because there is neither statutory authority authorizing block sampling nor recognized scientific accuracy in block sampling, in the absence of the consent of the audited taxpayer, when a taxpayer disagrees with the result of a block sample, the only remedy on appeal is a remand for a review of all records. *See* Det. No. 02-0114, 22 WTD 174, 181. Taxpayer did not provide sufficient records for Audit to perform a review of all records, and, absent other available

records, Audit performed the audit in the manner it deemed best to determine Taxpayer's tax liabilities for the Audit Period pursuant to RCW 82.32.100. Therefore, we conclude that Audit properly assessed Taxpayer using the block sample and sustain the assessment.

Panelist Costs

For January 1, 2006 to May 31, 2010, WAC 458-20-194 explains the apportionment of business activities for taxpayers doing business inside and outside of Washington, reporting under the service and other activities B&O tax classification. WAC 458-20-194 allows taxpayers to apportion business activities to Washington using a cost apportionment ratio equal to a taxpayer's cost of doing business in Washington divided by the total cost of doing business worldwide. WAC 458-20-194(4)(a)(i). A taxpayer's cost of doing business in Washington is equal to those costs specifically assigned to Washington plus all costs assigned to Washington by formula. WAC 458-20-194(4)(a)(ii).

Costs not specifically assigned ("other costs") are assigned to Washington by a formula equal to the ratio of sales in Washington over sales everywhere. WAC 458-20-194(4)(h)(i). Representative third-party costs are assigned to the third party's place of performance; thus, a third party would need to perform in Washington in order for the cost of the third party to be assigned to Washington. WAC 458-20-194(4)(g).

"Representative third party" includes an agent, independent contractor, or other representative of the taxpayer who provides services on behalf of the taxpayer directly to customers." WAC 458-20-194(4)(g)(i). Audit determined that Taxpayer's panelists provide no service directly to its customers because the panelists do not directly provide Taxpayer's customers with responses. Taxpayer does not allege otherwise; further it advertises that it provides strict panelist privacy and client confidentiality practices to maintain the integrity of the surveys. While Taxpayer may provide its customers with raw data from panelists, Taxpayer transmits the data from the panelists to its customers – the panelists do not directly send responses to customers. Therefore, because the panelists do not directly provide services to Taxpayer's customers, such panelist costs are properly classified as other costs for purposes of the apportionment ratio in WAC 458-20-194.

Refund Substantiation

1. 4th Quarter 2007

In accordance with our decision above, we find that Audit did not err in its 2006 block sample. Audit used the 2006 block sample to determine Taxpayer's apportionment percentage and then applied the apportionment percentage to the 4th Quarter 2007; accordingly, we find Taxpayer is not entitled to a refund.

2. 2008

WAC 458-20-229 provides guidance and explanation as to what documents a taxpayer must provide in substantiation of a refund request. WAC 458-20-229(3)(b) states as follows:

(v) The taxpayer is encouraged to file substantiation documents at the time of filing the application. However, once an application is filed, the taxpayer must submit sufficient substantiation to support the claim for refund or credit before the department can determine whether the claim is valid. The department will notify the taxpayer if additional substantiation is required. The taxpayer must provide the necessary substantiation within ninety days after such notice is sent, unless the documentation is under the control of a third party, not affiliated with or under the control of the taxpayer, in which case the taxpayer will have one hundred eighty days to provide the documentation. The department may request any other books, records, invoices or electronic equivalents and, where appropriate, federal and state tax returns to determine whether to accept or deny the claimed refund and to assess an existing deficiency.

(vi) In its discretion and upon good cause shown, the department may extend the period for providing substantiation upon its own or the taxpayer's request, which may not be unreasonably denied.

(vii) If the department does not receive the necessary substantiation within the applicable time period, the department shall deny the claim for lack of adequate substantiation and shall so notify the taxpayer.

(Emphasis added.) Rule 229(3)(b)(vii) states that if the Department does not receive the necessary substantiation within the applicable time period, the Department “shall” deny the claim for lack of adequate substantiation. Here, Audit properly denied Taxpayer’s refund claim for lack of substantiation.

DECISION AND DISPOSITION

Taxpayer’s petition is denied.

Dated this 9th day of May, 2014.