

Cite as Det. No. 17-0168, 37 WTD 042 (2018)

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

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. 17-0168
)	
... )	Registration No. . . .
)	

[1] RCW 82.32.330(1)(A) and (2): UNAUTHORIZED DISCLOSURES OF TAX INFORMATION. An unauthorized disclosure of taxpayer information does not occur when the Department sends information regarding an assessment to the Taxpayer for a relevant tax period, as opposed to its successor where the taxpayer is the successor’s sole owner and registered agent.

[2] RCW 82.26.060; WAC 458-20-185: OTHER TOBACCO PRODUCTS TAX – LACK OF ADEQUATE RECORDS. Taxpayer’s failure to maintain suitable records of other tobacco products handled during the audit period precludes a challenge to Audit’s estimate of its tax liabilities where the Taxpayer claims that the products confiscated by the Washington State Liquor and Cannabis Board were old and used only for display.

[3] RCW 82.32.140: LIABILITIES FOR PERIODS PRIOR TO TAXPAYER’S REORGANIZATION FROM SOLE PROPRIETOR TO LIMITED LIABILITY COMPANY (“LLC”). When a taxpayer that formerly operated as a sole proprietor reorganizes to an LLC, the department properly assesses the sole proprietor, as opposed to the LLC, for liabilities arising from periods preceding the reorganization.

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.

Stojak, T.R.O. – A retailer of other tobacco products (“OTP”) disputes an estimated assessment of tobacco products tax, moist snuff tax, and cigar tax on unlicensed purchases of OTP resulting from a Washington State Liquor and Cannabis Board (“WSLCB”) investigation. The retailer asserts that the Department overestimated the tax due for the audit period by failing to account for the age of the OTP found during the investigation. Taxpayer also asserts that the Department disclosed its successor’s confidential tax information by sending [Taxpayer] the assessment.<sup>1</sup>

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

## ISSUES

1. Has an unauthorized disclosure of confidential taxpayer information occurred, pursuant to RCW 82.32.330, when the Department sends information regarding an assessment to the Taxpayer for the relevant period as opposed to its successor?
2. When an OTP retailer fails to maintain adequate records of the OTP it handles, as required by RCW 82.26.060 and WAC 458-20-185, does the fact that some of the inventory upon which the Department based its estimated assessment predates the audit period present a basis for adjusting the assessment?
3. Under RCW 82.32.140, was the Department required to assess Taxpayer's successor in this case?

## FINDINGS OF FACT

For the tax periods of January 1, 2013, through March 31, 2016, . . . (“Taxpayer”) operated a smoke shop variety store. Taxpayer filed excise tax returns with the State of Washington for this period reporting income. Taxpayer closed its tax registration account with the Department, effective April 30, 2016.

On March 28, 2016, the WSLCB conducted [an] OTP investigation at Taxpayer's store. Pursuant to this investigation, WSLCB discovered OTP products that Taxpayer purchased from unlicensed tobacco distributors. Taxpayer did not have receipts for any of the OTP for sale at its store. WSLCB prepared an OTP inventory sheet itemizing Taxpayer's unlicensed tobacco product purchases and the associated wholesale price of the products. WSLCB estimated that Taxpayer made seven purchases per year of each of the products included on the inventory sheet and calculated a total OTP tax liability for the preceding four years of \$ . . . .

WSLCB referred Taxpayer's case to the Department for assessment of tax on the unlicensed purchases. On October 11, 2016, the Department's Taxpayer Account Administration Division (“TAA”) issued an assessment for January 1, 2013, through March 31, 2016 (“audit period”) against Taxpayer for \$ . . . . The assessment includes \$ . . . in tobacco products/cigar tax (only cigars that cost less than \$0.69 per cigar); \$ . . . in moist snuff tax (1.2 oz. or less); \$ . . . in moist snuff tax (more than 1.2 oz.); \$ . . . in cigar tax (cost per cigar \$0.69 or more); negligent penalty of \$ . . . ,<sup>2</sup> interest of \$ . . . , and a five percent assessment penalty of \$ . . . .

TAA based the tax amounts included in the assessment on the inventory sheet created by WSLCB. However, TAA reduced the estimate of the volume of purchases of the products listed on the

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<sup>2</sup> The Department must assess an additional penalty of ten percent when it finds that a taxpayer has failed to follow previously issued specific written instructions. RCW 82.32.090(5); WAC 458-20-228(5)(e). The Department sometimes refers to this as the “negligent penalty.” TAA provided specific written instructions to Taxpayer pursuant to Audit # . . . issued on June 9, 2006, pertaining to its responsibility to maintain accurate and complete records pertaining to its tobacco product purchases. The closing comments to the Examiner's Detail of Differences and Instructions to Taxpayer states, “[t]he instructions in this report constitute ‘specific written instructions’ within the meaning of RCW 82.32.090. Failure to follow the instructions may subject the taxpayer to the additional 10 percent penalty.”

inventory sheet from seven purchases a year to two purchases per year for cigars costing over sixty-nine cents and to four purchases a year for all other OTP.

Taxpayer petitioned for review of the assessment on October 26, 2016. Taxpayer's petition argues that TAA overestimated the volume of its purchases and asserts that many of the products that WSLCB found have been on its shelves for two to six years. Taxpayer also included its own inventory sheet with its petition. The inventory sheet created by Taxpayer includes all of the products itemized on the WSLCB inventory sheet and states its own estimate of the volume of purchases for each product. Taxpayer also attached a total of twenty invoices reflecting tobacco product purchases that document dates of purchase ranging from February 2010 to July 2016.

A hearing was held on this matter on March 20, 2016. At the hearing Taxpayer's representative brought a number of boxes of OTP inventory from Taxpayer's shelves. Taxpayer's representative presented OTP boxes during the hearing that appeared old. He also presented images on his laptop computer of OTP boxes on Taxpayer's shelves that appeared old. Taxpayer's representative submitted a list of forty-eight tobacco products that correspond to images on his laptop computer. Each itemized product and corresponding image includes a note. Twelve different products included on the itemized list indicate a date shown on the box in the note. Of these twelve products, the date shown predates the audit period for five of the products. Other notes included on the itemized list simply describe the relevant box as "old," or "empty."

At the hearing, Taxpayer's representative asserted that Taxpayer mainly sells stamped cigarettes and struggles to remain competitive. He asserted that Taxpayer retained boxes of old, unmarketable OTP product, as well as empty OTP boxes, in order to augment the display of products offered at the shop. Taxpayer's representative attested that he personally observed many OTP boxes with product expiration dates that had passed years ago. Based on these assertions, he argued that TAA significantly overestimated Taxpayer's unlicensed OTP purchases by using turnover rates of two to four purchases per year.

At the conclusion of the hearing, Taxpayer's representative presented information pertaining to a change in Taxpayer's business organization. He explained that in February of 2016 . . . ("Successor") purchased Taxpayer's tobacco shop. He further explained that Successor is an S corporation and Taxpayer holds one hundred percent of its shares. He argued that Successor now owns the inventory at issue, and as such, the Department assessed the wrong "person." He conceded that the Department could assess Successor, but argued that Successor's liability is limited to the value of the inventory at the time of the transfer. Furthermore, Taxpayer's representative charged that WSLCB and the Department disclosed Successor's confidential tax information when it sent the assessment and related correspondence to Taxpayer. He also asserted that the Department's continued pursuance of the assessment against Taxpayer would result in further disclosure of Successor's protected tax information.

The Department's records pertaining to Successor indicate that it applied for a business license and tax registration account on February 29, 2016. Its application indicates a date of incorporation of February 25, 2016. Successor also indicated on its application that Taxpayer serves as its sole governing person. Successor filed its first Washington excise tax return reporting income on May 23, 2016 for the monthly tax period of April 2016. During the administrative review process,

Taxpayer claimed that it filed its last monthly tax return, for the monthly tax period of March 2016, in error. It asserts that the transfer of ownership to Successor transpired in late February, and therefore, the March 2016 tax return should have been filed by Successor.

Finally, Taxpayer provided a copy of the corporate income tax return, Form 1120S, filed by Successor for the tax year ended December 31, 2016. This tax return indicates that Successor incorporated on February 25, 2016, and reports this day as the beginning of the tax year. Successor reported a beginning inventory of \$ . . . on Form 1125-A for the 2016 tax year.

### ANALYSIS

#### The Department's assessment in this case does not result in an unauthorized disclosure of tax information in this case

At the outset, we address the position taken by Taxpayer's representative that the Department disclosed, and will continue to disclose, confidential taxpayer information if it pursues the assessment in this case. Taxpayer's representative premises this claim on RCW 82.32.330. This statute protects confidential taxpayer information from unauthorized disclosures. RCW 82.32.330(2) states the core of the protection afforded. It provides: "Returns and tax information are confidential and privileged, and except as authorized by this section, neither the department of revenue nor any other person may disclose any return or tax information." RCW 82.32.330(1)(a) defines "disclose" as "to make known to any person in any manner whatever a return or tax information."

Taxpayer's representative claims that the inventory upon which the Department levied its assessment belongs to Successor, not Taxpayer. He [asserts] that the Department disclosed Successor's confidential taxpayer information when it sent the assessment and related correspondence to Taxpayer, the Successor's sole shareholder and registered agent. . . .

. . . [T]here must be an unauthorized disclosure of tax information in order for a violation of RCW 82.32.330(2) to occur. The assessment in this case pertains to tax periods during which Taxpayer operated the smoke shop and filed excise tax returns as a sole proprietor. . . . Taxpayer [also is] Successor's sole shareholder and registered agent . . . . Taxpayer is the sole individual with whom the Department *can* communicate regarding both [Taxpayer's] own activities, as well as Successor's activities. Under these circumstances, we fail to see how the Department "discloses" confidential tax information when it communicates with Taxpayer regarding matters involving either party.

#### TAA's estimate was proper

Washington imposes a tax upon tobacco product distributors for the sale, handling, or distribution of tobacco products in this state. RCW 82.26.020; see also RCW 82.26.030 ("It is the intent and purposes of this chapter to levy a tax on all tobacco products sold, used, consumed, handled, or distributed within this state and to collect the tax from the distributor as defined in RCW 82.26.010.").

The term “distributor” includes “any person engaged in the business of selling tobacco products in this state who handles for sale any tobacco products that are within this state but upon which tax has not been imposed.” RCW 82.26.010(8)(d). Thus, a tobacco products retailer who handles untaxed tobacco products becomes a tobacco products distributor, liable for the tobacco products tax on such items. RCW 82.26.010(8)(d); RCW 82.26.020. *See also* WAC 458-20-185(205) (“For example, if a retailer buys tobacco provided from an Indian retailer or an out-of-state wholesaler who does not have a tobacco distributor license, the retailer must obtain a distributor license and pay the tobacco tax due. . . .”).

Generally, tobacco products are subject to a tax equal to 95% of the taxable sales price.<sup>3</sup> RCW 82.26.020. However, certain tobacco products are subject to a separate and more specific, tax. As relevant here, cigars are subject to a tax equal to 95% of the taxable sales price of the cigars, not to exceed 65 cents per cigar.<sup>4</sup> RCW 82.26.020(1)(a). Little cigars are subject to a tax equal to 12.125 cents per little cigar. RCW 82.26.020(1)(d); RCW 82.24.020(1).

Here, Taxpayer does not dispute that it meets the definition of a “distributor” and owes tax on its untaxed tobacco products. Instead, Taxpayer disputes TAA’s estimate of the volume of untaxed products that it handled. Taxpayer claims that it retained old, unmarketable boxes of tobacco products in order to fill-in its shelves and avoid the appearance of a shop struggling to survive. Taxpayer contends that the majority of boxes of untaxed tobacco products WSLCB included in its inventory had been on its shelves for several years. Based on this contention, Taxpayer asserts TAA overestimated the volume of untaxed tobacco products it handled during the audit period by estimating a turnover of two to four purchases a year for the products included in the inventory.

RCW 82.26.060 explains a tobacco product distributor’s obligation to maintain and provide, the Department, with purchase records. In pertinent part, it states as follows:

(1) Every distributor shall keep at each place of business complete and accurate records for that place of business, including itemized invoices, of tobacco products held, purchased, manufactured, brought in or caused to be brought in from without the state, or shipped or transported to retailers in this state, and of all sales of tobacco products made.

(2) These records shall show the names and addresses of purchasers, the inventory of all tobacco products, and other pertinent papers and documents relating to the purchase, sale, or disposition of tobacco products. All invoices and other records required by this section to be kept shall be preserved for a period of five years from the date of the invoices or other documents or the date of the entries appearing in the records.

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<sup>3</sup> “Taxable sales price” is statutorily defined. In pertinent part, RCW 82.26.010(19)(a)(i) states: “In the case of a taxpayer that is not affiliated with the manufacturer, distributor, or other person from whom the taxpayer purchased tobacco products, the actual price for which the taxpayer purchased the tobacco products.” If the purchaser and seller are affiliated, RCW 82.26.010(19) provides several other potentially applicable definitions.

<sup>4</sup> The tax assessment’s distinction between cigars that cost 69 cents or more and cigars that cost less than 69 cents, reflects the statutory cigar tax cap of 65 cents per cigar.

WAC 458-20-185(401)(a) explains, “The itemized invoice for each purchase or sale must be legible and must show the seller’s name and address, the purchaser’s name and address, the date of sale, and all prices and discounts.” *See also* RCW 82.32.070(1) (“Every person 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. . .”). Should a taxpayer not keep and preserve such records, the Department may proceed to do its best to estimate tax due, based upon the records provided. RCW 82.26.120, RCW 82.32.100(1).<sup>5</sup>

Taxpayer’s failure to maintain suitable records pertaining to the OTP it handled during the audit period dictates the result in this case. Although Taxpayer submitted twenty purchase invoices with its petition, the overall record of Taxpayer’s purchases during the audit period remains incomplete. Taxpayer failed to maintain and provide the Department with all of its purchase records as required by RCW 82.26.060. It also failed to maintain and provide an inventory of the tobacco products handled during the audit period as required by RCW 82.26.060(2). Without these records, TAA maintained the discretion to [reasonably] estimate Taxpayer’s OTP sales in the manner it deemed best as provided under RCW 82.32.100. [On these facts, we hold that the estimate was reasonable.]

The fact that Taxpayer maintained old boxes of OTP that WSLCB included in its inventory does not change the result in this case. Taxpayer does not dispute that it purchased untaxed OTP during the audit period. It also does not dispute that it failed to maintain a complete record of its tobacco purchases and inventory during the audit period. Accordingly, we find no basis for adjusting TAA’s assessment in this case.

#### TAA assessed the correct taxpayer

RCW 82.32.140 outlines specific requirements pertaining to taxpayers that quit their business and transfer their assets. It also provides the consequences for failing to meet these requirements. RCW 82.32.140 provides as follows:

(1) Whenever any taxpayer quits business, or sells out, exchanges, or otherwise disposes of more than fifty percent of the fair market value of either its tangible or intangible assets, any tax payable hereunder shall become immediately due and payable, and such taxpayer shall, within ten days thereafter, make a return and pay the tax due, unless an extension is granted under RCW 82.32.080.

(2) Any person who becomes a successor shall withhold from the purchase price a sum sufficient to pay any tax due from the taxpayer until such time as the taxpayer shall produce a receipt from the department of revenue showing payment in full of any tax due or a certificate that no tax is due. If any tax is not paid by the taxpayer within ten days from the date of such sale, exchange, or disposal, the successor shall become liable for the payment of the full amount of tax. If the fair market value of the assets acquired by a successor is less than fifty thousand dollars, the successor’s liability for payment of the unpaid tax is limited to the fair market value of the assets acquired from the taxpayer. The burden of establishing the fair market value of the assets acquired is on the successor.

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<sup>5</sup> All of the provisions contained in chapter [82.32](#) RCW shall have full force and application with respect to taxes imposed under the provisions of this chapter. RCW 82.26.120.

Taxpayer asserts that TAA assessed the wrong taxpayer. It contends that at the time of the WSLCB investigation, Successor owned the inventory upon which TAA based its estimate of Taxpayer's liability, and therefore, the assessment should have been made against Successor. Furthermore, Taxpayer contends that the value of the inventory transferred limits the amount the Department can assess Successor.

We find no support for Taxpayer's assertion that TAA assessed the wrong person. As discussed, the assessment in this case pertains to tax periods during which Taxpayer, as a sole proprietor, operated the smoke shop and filed excise tax returns. Taxpayer's transfer of the inventory upon which TAA based its estimate for the audit period does not expunge its liability for the audit period. Although RCW 82.32.140 *permits* the Department to proceed against Successor in this case, it does not *require* it to do so.<sup>6</sup> Here, Taxpayer operated the smoke shop during the audit period. Taxpayer remains liable for its tax debts stemming from this period. Accordingly, we find no basis for Taxpayer's assertion that the Department assessed the wrong taxpayer. Because the Department assessed Taxpayer, and not Successor, we decline to address Taxpayer's argument regarding the amount that the Department can assess Successor.

#### DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 6th day of July 2017.

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<sup>6</sup> The Division II Court of Appeals recently addressed the concept of successor liability in general. In, *Columbia State Bank v. Invicta Law Group PLLC*, No. 73915-8-I, 2017 WL 2229924, the court noted, “[s]uccessor liability requires an underlying cause of action and merely extends the liability on that cause of action to a corporation *that would otherwise not be liable.*” *Id.* at 11 (emphasis added). As relevant here, RCW 82.32.140 does not limit the Department's ability to assess a taxpayer for its own liabilities after it sells or transfers its assets; it simply provides a mechanism for the Department to proceed directly against a Successor upon a taxpayer's dissolution.