

Cite as Det. No. 18-0180, 38 WTD 253 (2019)

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

In the Matter of the Petition for)	<u>D E T E R M I N A T I O N</u>
Correction of Assessment of)	
)	No. 18-0180
)	
...)	Registration No. . . .
)	

[1] RULE 254; RCW 82.32.070: RECORDKEEPING – UNRELIABLE RECORDS – DATA IRREGULARITIES. A taxpayer fails to maintain suitable records from which the Department may determine tax liability where its only record of sales is its point of sale (POS) system that contains a variety of irregularities and proves unreliable. Such irregularities include: a high percentage of transactions with unexplained missing menu line items recorded in a manner that is contradicted by the POS system manufacturer; missing test cash transactions made by the Audit Division staff; and POS system reports that show a cash sales percentage significantly lower than industry averages.

[2] RULE 254; RCW 82.32.070; RCW 82.32.100: RETAIL SALES TAX – RETAILING B&O TAX – RECORDKEEPING – REASONABLE ESTIMATES. Where a taxpayer’s records prove unreliable, the Department is required to estimate the taxpayer’s tax liability based on the facts and information available. The Department has wide discretion to calculate an estimate of tax liability as long as the methodology employed is reasonable. The Department’s use of customer payment practice studies and industry averages to estimate cash sales is a reasonable method where taxpayer records are shown to be unreliable or incomplete.

[3] RULE 228; RCW 82.32.090: RETAIL SALES TAX – EVASION PENALTY – INTENT TO EVADE. Evidence that a taxpayer’s records contain a variety of unexplained irregularities and illustrate a pattern of the taxpayer’s creation and maintenance of business records that show a reduction of the amount of sales, is clear, cogent, and convincing evidence that the taxpayer intentionally created or maintained those records in order to escape detection of its tax liability and wrongfully evade payment of taxes.

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.

Eckholm, T.R.O. – A restaurant business seeks review of an assessment of retail sales tax, retailing business and occupation (B&O) tax, and evasion penalty. The taxpayer asserts that unreported sales were unreasonably estimated and the Department has not established the requirements for the imposition of the evasion penalty. The Department holds that the taxpayer failed to maintain suitable records and that the Audit Division reasonably estimated unreported sales and tax liability. The Department also holds that clear, cogent and convincing evidence established that the taxpayer intentionally evaded payment of tax and required imposition of the evasion penalty. The Department denied the taxpayer’s petition.¹

ISSUES

1. Has the taxpayer met its obligation to maintain suitable records from which the Department may determine its tax liability, as required by RCW 82.32.070 and WAC 458-20-254?
2. In the absence of suitable taxpayer records, did the Department reasonably estimate tax liability, under RCW 82.32.100(1), based on audit findings and industry averages?
3. Is there clear, cogent and convincing evidence to establish the imposition of the evasion penalty under RCW 82.32.090(7)?

FINDINGS OF FACT

. . . (the taxpayer) is a Washington corporation engaged in the business of operating a full-service restaurant that specializes in . . . cuisine in . . . Washington. The Department of Revenue (Department) Audit Division conducted an audit of the taxpayer’s Washington business activities for the period of April 1, 2010, through June 30, 2014. Based on a review of the taxpayer’s business records and operations, the Audit Division concluded that the taxpayer had underreported its cash sales on its excise tax returns. As a result, the Department issued an assessment against the taxpayer in the total amount of \$. . . , composed primarily of retail sales tax.²

The Audit

Prior to the audit, Audit Division staff visited taxpayer’s restaurant and made two cash purchases as a test. The first purchase was on March 21, 2013, for a dine-in lunch, and the second was on October 12, 2013, for an order to-go. The guest check receipts for the purchases contained itemized menu items and the retail sales tax was collected by taxpayer.

The Audit Division requested a number of business records from the taxpayer. The taxpayer provided federal income tax returns, depreciation schedules, bank statements, point of sale (POS) monthly summary reports, and some purchase invoices. The taxpayer indicated that it uses the POS monthly summary reports to calculate and report its excise taxes. The POS monthly summary reports showed that from August 2011 (when the taxpayer began using the POS system) through

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

² Document No. . . . , issued May 26, 2017, includes assessment of retail sales tax of \$. . . , retailing B&O tax of \$. . . , use tax and/or deferred retail sales tax of \$. . . , an evasion penalty of \$. . . , and interest of \$. . . , for a total amount of \$

March 2013, cash sales averaged 8.2 percent of total sales. The Audit Division concluded that the cash sales percentage was significantly below industry standards and requested additional purchase invoices and the POS detailed daily sales report for March 2013. The taxpayer provided additional receipts and POS reports but stated that it was not possible to create a detailed daily sales report using its POS system.

The taxpayer subsequently provided the auditors a tour of the restaurant and, upon auditor request, restaurant staff printed a POS detailed daily sales report for March 2013. The auditors could not trace the March 21, 2013, test cash purchase within the daily sales report. The Audit Division requested additional POS reports and other records from the taxpayer, and the auditors could not trace either the March or October 2013 test cash purchases through the POS reports provided.

In reviewing the POS data, the Audit Division noted that there was a high percentage of transactions that contained inconsistent sequencing of menu line items. Rather than having a sequential order of menu line items in a transaction, there were missing line items from the sequence. For example, for the type of POS system used by the taxpayer, a transaction that contained six menu items should appear sequentially as menu line items 1, 2, 3, 4, 5, 6. The transaction should not indicate only line items 1, 2, 4 and 6, unless there was a corresponding void or error code and reason for voiding menu item lines 3 and 5. The Audit Division was not able to recreate these types of non-sequential results using the same type of POS system used by the taxpayer. If the Audit Division voided or changed a menu item in a test transaction, the line item numbers shifted up to a sequential order or the voided line item appeared as a negative numerical line item with an error code.

The auditors also reviewed the taxpayer's bank statements which showed small, infrequent cash deposits that could not be reconciled with the cash sales represented in the POS data. In addition, the taxpayer's federal income tax returns showed very low expense to income ratios as compared to restaurant industry benchmarks for a full-service restaurant.³

The Audit Division noted the above-described irregularities as consistent with an underreporting of cash sales and concluded that not all of the taxpayer's cash sales were reported. Based on the audit findings and industry averages, the Audit Division determined that a cash sales average of 25 percent of total sales was a conservative estimate to calculate the taxpayer's underreported income. For comparison, the Audit Division used several studies of consumer payment practices which reported industry consumer cash payments averaging from 27 percent of total sales to 55 percent of sales.⁴ Lower-priced retailers, such as fast-food businesses, represented the high-end of the range.⁵ The taxpayer's restaurant is a full-service, moderately-priced restaurant. The Audit Division conservatively estimated the taxpayer's underreported cash sales at 25 percent of total sales, which falls below the industry averages indicated in all of the studies.

³ Baker Tilly, *Restaurant Benchmarks: How Does Your Restaurant Compare to the Industry Standards?* (2014).

⁴ See Hitachi Consulting and BAI, *2010 Study of Consumer Payment Preferences* (2010) (industry averages specific to restaurants, according to menu price range); Claire Greene, Federal Reserve Bank of Boston, *U.S. Consumer Payment Choice* (2015); Bennett, Conover, O'Brien and Advincula, Federal Reserve Bank of San Francisco, *Cash Continues to Play a Key Role in Consumer Spending* (2014).

⁵ See Hitachi Consulting and BAI, *2010 Study of Consumer Payment Preferences* (2010).

Administrative Review

The taxpayer asserted on review that the Audit Division had not established that the POS summary monthly reports were inaccurate and that the Audit Division's cash sales estimate was too high. The taxpayer admitted that it had underreported sales and owed retail sales tax but that restaurant industry benchmarks indicated a lower cash sales percentage, according to its calculations. In making this admission, the taxpayer did not have an explanation for how it could know it underreported cash sales and at the same time assert that the POS summary reports that it used for excise tax reporting were accurate. The taxpayer suggested employee theft could be the cause of its underreporting but did not explain how employee theft could have caused the non-sequential line items in the POS detail.

Regarding the Audit Division test cash purchases in March and October 2013, the taxpayer indicated that it located the "JobID" (transaction number) for each of these transactions in the JobID POS database report. The taxpayer provided a report that indicated the transactions were voided and asserted that it was possible the transactions were not completed. The taxpayer also asserted that it was questionable whether payment was made for the test cash purchases because the guest check tickets do not indicate payment was made and the only evidence of payment is the statements by the Audit Division staff.

The taxpayer submitted a copy of an email from a representative of the POS software manufacturer in support of its assertions. The email indicated that voiding or changing a menu item in a transaction would be represented in the POS detail as the voided menu line item number added to negative 1000. For example, if menu line item 3 is voided in a transaction with six menu items, the transaction sequencing would appear as 1, 2, 4, 5, 6, - 997.

The taxpayer calculated its expense to income ratios differently and asserted that its calculations came closer to the industry averages. The taxpayer asserted that the corporate officers' salaries should be included in the wage to income ratio computation and their time should be included in determining the minimum number of hours to operate the business.

The Audit Division responded that the location of the two test cash transactions in the JobID database report with void codes is inconsistent with the other POS database reports and the creation of the guest checks. The Audit Division indicated that it was not possible to create a guest check ticket without the information contained in the other POS databases and that the test cash transactions did not appear in any of the other POS database reports. The guest check header information (date, time, table, server, etc.), the items ordered (quantity and amount), and the amount due (subtotal, tax and grand total) all come from separate POS databases. The Audit Division explained that the POS system pulls information from each database to create a guest check. The Audit Division also indicated that it is not possible to pick up a carryout order without payment. The Audit Division offered to provide sworn declarations if the taxpayer objected to the veracity of the Audit Division's statements and the taxpayer declined this offer. In addition, the Audit Division indicated that the two corporate officers' salaries should not be included in wage to income calculation because one officer lives out of state and the other has a full-time job. But even if the salaries were included, the wage to income ratio would still fall below industry averages.

The taxpayer also disputed the assessment of the evasion penalty on the basis that the Audit Division failed to show by clear, cogent, and convincing evidence that the taxpayer intended to evade the payment of tax. The taxpayer asserted that the lack of evidence that the taxpayer collected payment for the test cash transactions (beyond the Audit Division's statements) creates doubt as to whether sales tax was collected or intentionally not remitted. The taxpayer indicated that the inconsistent POS database reports could be the result of a dishonest employee or some other reason. The taxpayer asserted that it relied on the POS summary monthly reports to report its tax liability and it had no reason to believe the reports were inaccurate. The taxpayer stated that neither inconsistency between cash deposits and reported cash sales nor expense to income ratios below industry averages is evidence of any taxpayer effort to evade payment of tax.

ANALYSIS

Washington imposes a retail sales tax on each retail sale in this state. RCW 82.08.020(1). Sales of prepared food and beverage to consumers are retail sales subject to retail sales tax unless a specific exemption applies. *See* RCW 82.04.050(1)(a); WAC 458-20-124. Taxpayers who sell prepared food and beverage at retail are also subject to retailing business and occupation tax on their gross proceeds of sales. RCW 82.04.250. *See* RCW 82.04.070 ("gross proceeds of sales" defined).

Estimated Tax Liability

Taxpayers are required to maintain suitable records from which the Department may determine the taxpayer's tax liability and verify that the taxpayer correctly reported its tax liability to the Department. *See* RCW 82.32.070(1); WAC 458-20-254. Specifically, RCW 82.32.070(1) provides:

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. . . .

If a person fails to meet this obligation to keep suitable records for the Department's examination, RCW 82.32.100(1) provides that the Department "shall proceed, in such manner as it may deem best, to obtain facts and information on which to base its estimate of the tax . . ." This statutory provision affords the Department-wide discretion in the methodology employed to calculate a reasonable estimate of tax liability. *See, e.g.*, Det. No. 16-0408, 36 WTD 490, 493 (2017); Det. No. 15-0350, 35 WTD 291 (2015).

The evidence presented in this case indicates that the taxpayer failed to maintain suitable records from which the Department may determine tax liability. As detailed above, a variety of irregularities indicated that the taxpayer's POS data was not reliable: a high percentage of transactions contained missing menu line items without explanation and in contradiction to the POS system manufacturer's statements and POS data; the missing test cash transactions made by

the Audit Division staff; the comparatively low percentage of cash transactions reported for a restaurant of this type; and expense to income ratios below industry averages.

These irregularities occurring together indicate the taxpayer's electronic data is unreliable and the need for the Department to estimate unreported sales under RCW 82.32.100(1). Here, the Audit Division estimated unreported sales at 25 percent of total sales based on the audit findings and industry studies of customer payment practices.⁶ The Department's use of industry averages to estimate unreported sales is reasonable where taxpayer records are shown to be unreliable or incomplete. *See, e.g.*, Det. No. 12-0136, 32 WTD 65 (2013); Det. No.13-0302R, 33 WTD 572 (2014); 35 WTD 291. The Department's authority to estimate tax liability is similar to the discretion afforded the IRS in generating assessments of tax liability. In addressing the similar authority of the IRS to estimate, the United States Supreme Court has stated:

[G]ranting the IRS assessment authority, must simultaneously grant the IRS power to decide how to make that assessment—at least within certain limits. And the courts have consistently held that those limits are not exceeded when the IRS estimates an individual's tax liability—as long as the method used to make the estimate is a “reasonable” one. . . .

United States v. Fior D'Italia, Inc., 536 U.S. 238, 243, 122 S.Ct. 2117, 153 L.Ed.2d 280 (2002).⁷

In this case, the Audit Division reasonably estimated unreported sales at 25 percent of total sales given that industry studies show a minimum average of 27 percent cash sales to total sales. The Audit Division 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 a reasonable estimate of unreported tax. The taxpayer has not shown that the method employed by the Audit Division produced an unreasonable estimate.

⁶ *Supra*, note 4.

⁷ The *Fior* Court goes on to detail a variety of instances when an estimate of tax liability was reasonable and also addresses the range of information that can provide a reasonable basis for the estimate:

See, e.g., *Erickson v. Commissioner*, 937 F.2d 1548, 1551 (C.A.10 1991) (estimate made with reference to taxpayer's purchasing record was “presumptively correct” when based on “reasonable foundation”). *See also Janis*, *supra*, at 437, 96 S.Ct. 3021 (upholding estimate of tax liability over 77-day period made by extrapolating information based on gross proceeds from five-day period); *Dodge v. Commissioner*, 981 F.2d 350, 353-354 (C.A.8 1992) (upholding estimate using bank deposits by taxpayer); *Pollard v. Commissioner*, 786 F.2d 1063, 1066 (C.A.11 1986) (upholding estimate using statistical tables reflecting cost of living where taxpayer lived); *Gerardo v. Commissioner*, 552 F.2d 549, 551-552 (C.A.3 1977) (upholding estimate using extrapolation of income over one-year period based on gross receipts from two days); *Mendelson v. Commissioner*, 305 F.2d 519, 521-522 (C.A.7 1962) (upholding estimate of waitress' tip income based on restaurant's gross receipts and average tips earned by all waitresses employed by restaurant); *McQuatters v. Commissioner*, 32 TCM 1122, 1973 WL 2419 (1973), ¶ 73,240 P-H Memo TC (same).

536 U.S. at 243-4.

Evasion Penalty

The Department is required to assess a 50-percent evasion penalty if it finds that any part of a tax deficiency resulted from an intent to evade the tax. RCW 82.32.090(7). The Department's administrative rule that explains the application of the evasion penalty, WAC 458-20-228, provides, 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 attempt by the taxpayer to escape taxation through deceit, fraud, or other intentional wrongdoing. *Id.*; *see also* Det. No. 13-0329, 33 WTD 156 (2013). 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 91 (1993).

Here, the taxpayer admits that it had knowledge of its tax liabilities but disputes that it attempted to escape detection or payment of the tax liability through deceit, fraud, or other intentional wrongdoing. "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 . . ." *State v. Gaul*, 88 Wash. 295, 301, 152 P. 1029 (1915). As a result, intent is usually inferred or gathered from the words or acts of the person entertaining it, and the facts or circumstances surrounding the alleged offense. *Id.*; *State v. Farley*, 48 Wn.2d 11, 21, 290 P.2d 987 (1955). Therefore, intent is objectively discerned from the collection of evidence viewed as a whole and need not be proved by any single piece of evidence. *See Gaul*, 88 Wash. at 301; *Farley*, 48 Wn.2d at 20-21.

Here, the numerous irregularities within the business records created and maintained by the taxpayer evidence an attempt to escape tax liability by reducing the amount of taxable sales reflected in its records. First, the taxpayer's POS data shows a high percentage of transactions containing missing menu line items and the taxpayer has not provided any explanation for these occurrences. Indeed, the evidence presented by the taxpayer from the POS system manufacturer establishes that any interruption in sequential menu line items because of an item void or change would be represented by a code and negative number. The high percentage of the missing item lines suggest system error is unlikely and the manufacturer makes no mention of such system errors. Second, the test cash purchases by the Audit Division staff do not appear in the POS databases from which data is pulled to create the guest checks the staff received. The taxpayer's identification of the two voided transactions in the POS JobID database report is inconsistent with the absence of the transactions in the other POS databases. Third, the POS monthly summary

reports used by the taxpayer to report tax liability show a cash sales percentage of 8.2 percent of total sales, which is significantly lower than industry averages for medium-priced, full service restaurants. Finally, the taxpayer's expense to income ratios are much lower than industry averages.

Taken together, these irregularities illustrate a pattern of the taxpayer's creation and maintenance of business records that indicate a reduction of the amount of sales. The taxpayer failed to explain the irregularities in its records. The taxpayer made a general assertion of suspected employee theft but offered no explanation as to how theft could cause the high volume of missing lines in the POS data and other irregularities in the taxpayer's records. The taxpayer stated that it reported its tax liability to the Department based on the amounts listed in its POS summary monthly reports. The numerous irregularities in the POS data resulted in reduced sales amounts in the POS monthly summary reports from which the taxpayer reported its tax liability.

The evidence in this case, taken as a whole, is clear, cogent, and convincing evidence that the taxpayer intentionally created or maintained business records that represented a reduced amount of sales in order to escape detection of its tax liability and wrongfully evade payment of taxes. The taxpayer offered no evidence that the numerous irregularities in its business records and resulting tax deficiency were the result of an honest mistake, miscommunication, or the lack of knowledge regarding proper accounting methods. *See* WAC 458-20-228(5)(f) (providing example circumstances under which intent to evade tax does not exist). The evasion penalty was properly imposed in this case, as required by RCW 82.32.090(7).

DECISION AND DISPOSITION

The taxpayer's petition is denied.

Dated this 26th day of June 2018.