

Cite as Det. No. 18-0202, 38 WTD 266 (2019)

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. 18-0202
)	
...)	Registration No. . . .
)	

RCW 82.08.020; RCW 82.32.100; WAC 458-20-254: RETAIL SALES TAX AND RETAILING B&O TAX – REASONABLE ESTIMATES – DISCRETIONARY USE OF SAMPLING METHODOLOGY. Although the Department may choose, with a taxpayer’s consent, to employ a sampling methodology as a proxy to derive, as nearly as possible, the taxpayer’s true tax liability in any given case over a given time period, no authority exists to obligate the Department to use such a methodology in any particular case.

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.

L. Roinila, T.R.O. – An out-of-state producer and supplier of enzyme reagents for use in life sciences research argues that, since the Department did not use a sampling methodology in assessing unreported retail sales tax, and associated penalties, the Department acted unreasonably. Petition denied.¹

ISSUES

Whether, under RCW 82.08.020, the Compliance Division properly assessed retail sales tax on sales where the taxpayer failed to provide evidence of exemption rather than sampling a population of sales selected by the taxpayer?

FINDINGS OF FACT

. . . (Taxpayer) is [an out-of-state] based producer and supplier of recombinant and native enzyme reagents for use in life sciences research. Among its customers are major Washington universities, private research facilities, and instrumentalities of state and federal government.

In 2017, the Department’s Compliance Division (Compliance) discovered Taxpayer conducting taxable business in Washington without having registered to do so. As a result, Compliance

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

commenced a limited examination of the Taxpayer’s books and records² for the extended period of January 1, 2010, through December 31, 2016.³ During the course of the review, Compliance made two primary findings.

First, Compliance found that, since Taxpayer regularly sent nonresident employees to Washington to attend trade shows and conferences to speak about its products, Taxpayer possessed nexus sufficient to allow the state to exert its taxing authority. Second, Compliance concluded that, throughout the review period, Taxpayer had made, but failed to report, wholesale and retail sales into Washington. Believing that many of its sales to Washington customers were exempt from retail sales tax, the Taxpayer conducted an “. . . letter campaign”⁴ after the audit commenced. According to the Taxpayer, this campaign showed that Taxpayer made \$. . . in sales to its largest fifty (50) Washington customers during the audit period. Of this amount, \$. . . , or 94.6 percent, were made to customers that either possessed direct pay permits or were otherwise exempt from retail sales tax, such as sales to the federal government instrumentalities. Compliance deducted these amounts from Taxpayer’s gross income for purposes of the retail sales tax and assessed retail sales tax on the remainder of Taxpayer’s Washington sales. In addition, Compliance also assessed wholesaling and retailing B&O tax on the entirety of Taxpayer’s Washington gross income. The Department then issued two assessments against Taxpayer, one addressing 2011 and 2012, and the other covering 2013 through 2016.⁵ Compliance also imposed a twenty-nine percent delinquent penalty, a five percent assessment penalty, a five percent unregistered business penalty, and interest.

After Taxpayer called to the Department’s attention certain, minor errors in the original assessments, Compliance completed and issued post-assessment adjustments as follows:

	2010	2011	Total
Retail Sales Tax	\$. . .	\$. . .	\$. . .
Retailing B&O Tax	\$. . .	\$. . .	\$. . .
Wholesaling B&O Tax	\$. . .	\$. . .	\$. . .
Total Debit	\$. . .	\$. . .	\$. . .
29% Delinquent Penalty	\$. . .	\$. . .	\$. . .
5% Assessment Penalty		\$. . .	\$. . .
5% Unregistered Bus. Penalty		\$. . .	\$. . .
Interest	\$. . .	\$. . .	\$. . .
Total Assessed	\$. . .	\$. . .	\$. . .
Additional Interest			\$. . .

² Compliance examined Taxpayer’s completed Washington Business Activities Questionnaire (Questionnaire), and information culled from subsequent communications with Taxpayer’s controller, including final sales figures and gross revenue.

³ Since Taxpayer had engaged in unregistered business in Washington, Compliance was able to extend the review period beyond the normal statutory period. See RCW 82.32.050.

⁴ Taxpayer Review Petition, *In the Matter of the Petition for Correction of Assessment of . . .*, (2018) (no. . . .). An . . . letter is a letter sent to a customer from whom a taxpayer did not obtain a resale certificate or other valid proof of the customer’s exemption from taxation. Such letters are common in California, which specifically allows their use to rebut the state’s presumption of taxability. See Cal. Code Regs. Tit. 18, §1668(f) (2018).

⁵ Compliance assessed wholesaling B&O tax on Taxpayer’s income on sales to resellers and retailing B&O and sales tax on Taxpayer’s sales to end users.

Total Due						\$. . .
	2012	2013	2014	2015	2016	Total
RST	\$. . .	\$. . .	\$. . .	\$. . .	\$. . .	\$. . .
Retailing	\$. . .	\$. . .	\$. . .	\$. . .	\$. . .	\$. . .
Wholesaling	\$. . .	\$. . .	\$. . .	\$	\$. . .
Total Debit	\$. . .	\$. . .	\$. . .	\$. . .	\$. . .	\$. . .
Del. Penalty	\$. . .	\$. . .	\$. . .	\$. . .	\$. . .	\$. . .
Assessment Penalty					\$. . .	\$. . .
Unregistered Bus. Penalty					\$. . .	\$. . .
Interest	\$. . .	\$. . .	\$. . .	\$. . .	\$. . .	\$. . .
Total Assessed						\$. . .
Additional Interest						\$. . .
Total Due						\$. . .

Taxpayer timely petitioned us for review, arguing, primarily, that Compliance erred in its methodology. Rather than assessing retail sales tax, and penalties, on each sale for which Taxpayer could not provide an “. . . letter,” or other valid proof of exemption from retail sales tax, Taxpayer contends [Compliance] should have employed a random sampling method, as other state revenue departments have done when examining the Taxpayer.

ANALYSIS

Retail sales of tangible personal property in Washington are subject to retail sales tax. RCW 82.08.020(1)(a). This tax must be collected by the seller from the buyer and held in trust until paid to the Department. RCW 82.08.050(1), (2). Accordingly, if any seller fails to collect the tax, the seller is personally liable to Washington for the amount of the tax. RCW 82.08.050(3).

Likewise, RCW 82.12.020 imposes Washington’s use tax, stating, “[T]here is hereby levied and there shall be collected from every person in this state a tax or excise for the privilege of using within this state as a consumer any article of tangible personal property purchased at retail” RCW 82.12.020(1). WAC 458-20-178 (Rule 178) implements the statute, providing in relevant part:

What is use tax? Use tax complements the retail sales tax, and in most cases mirrors the retail sales tax. Articles of tangible personal property used or certain services purchased in Washington are subject to use tax when the state's retail sales tax has not been paid, or where an exemption is not available. Tangible personal property or services used or purchased by the user in any manner are taxable including, but not limited to:

- Purchases directly from out-of-state sellers;
- Purchases through the internet, telemarketing, mail order; or
- Acquisitions at casual or isolated sales. WAC 458-20-178(2).

In general, then, the use tax applies upon the use of any tangible personal property, the sale or acquisition of which has not been subjected to the Washington retail sales tax. RCW 82.12.020; Rule 178. Conversely, it does not apply to the use of any property if the sale has been subjected to the Washington retail sales tax, and such tax has been paid on acquisition. *Id.* Thus, these two methods of taxation stand as complements to each other in the state's revenue plan, and taken together, provide a uniform tax upon the sale or use of all tangible personal property, regardless of where it may have been purchased or how acquired. *See* Det. No. 13-0312, 34 WTD 006 (2015); Det. No. 04-0266, 25 WTD 1 (2006).

Here, Taxpayer does not claim that the sales at issue are not retail sales, and thus not subject to retail sales tax. Rather, the Taxpayer argues that the vast majority of the Washington customers to whom these sales were made either possess a direct pay permit, "self-assess" use tax, or are otherwise exempt from both retail sales and use tax.

Washington will, indeed, relieve a seller of its obligation to collect and remit sales tax, if the seller obtains from the customer a copy of a valid direct pay permit issued under RCW 82.32.087.⁶ RCW 82.08.050(7)(d). Such permits allow "the taxpayer to accrue and remit directly to the [D]epartment use tax on the acquisition of tangible personal property. . . ." RCW 82.32.087(1). Compliance allowed this Taxpayer retail sales tax deductions in connection with its sales to holders of valid direct pay permits. Similarly, Compliance allowed Taxpayer retail sales tax deductions for the sales where it was able to show that Taxpayer's Washington customer self-assessed use tax and remitted it to the Department as well. Finally, Compliance also did not assess retail sales tax on transactions where Taxpayer showed that the sales were not subject to retail sales tax, such as sales to the United States Government under WAC 458-20-190. Accordingly, Compliance has already excluded each of these kinds of sales from its calculation of sales subject to retail sales tax.

Regardless of the particular exemption upon which a taxpayer seeks to rely, "sellers are not relieved from personal liability for the amount of tax unless they maintain proper records of exempt or nontaxable transactions and provide them to the [D]epartment when requested." RCW 82.08.050(4). WAC 458-20-254(1) further provides that it is incumbent upon taxpayers "to retain and make available those records necessary to verify that the correct tax liability has been reported and paid by the taxpayer with respect to the taxes administered by the [D]epartment. . . ." Likewise, we have held that:

We do not agree that the taxpayer should receive a credit for retail sales tax on the assumption that some purchasers who did not respond to taxpayer's inquiries paid the tax directly to the state or were purchasing for resale. Arguably, many of those that did not respond had not remitted the tax and did not want to pay the tax owing.

⁶ RCW 82.32.087 authorizes the Department to grant a direct pay permit to a Washington taxpayer that demonstrates it satisfies certain requirements. RCW 82.32.087(1). Taxpayer can apply for a direct pay permit if (1) the taxpayer reasonably expects to have a cumulative tax liability of \$240,000, or more in the current year, or (2) the taxpayer makes purchases subject to sales or use tax of more than \$10,000,000 in the current year. RCW 82.32.087(2).

Det. No. 88-6, 4 WTD 417 (1987). Here, however, Taxpayer seeks, in essence, to circumvent these requirements by arguing that, since the Department did not employ a sampling methodology, the Department acted unreasonably.

The goal of a sales and use tax audit is to identify the total amount of underpaid or overpaid tax for the period under review. Det. No. 02-0114, 22 WTD 174 (2003). For many businesses, particularly those with large numbers of transactions, it can be a costly and time consuming endeavor for both the taxpayer and the Department to review all records for the entire period of review. As a result, the Department recognizes that a sampling of documents, rather than a review of all the records for the entire period, with the results projected to the entire period, is a commonly used and accepted audit method.

In block sampling, for example, the auditor chooses a group or block of transactions that occurred 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, e.g., Det. No. 14-0156, 34 WTD 196 (2015); Det. No. 88-233, 6 WTD 59 (1988); Det. No. 87-354, 4 WTD 293 (1987); Det. No. 93-240, 13 WTD 269 (1994).

The Department has also frequently used statistical sampling, which uses a randomly selected sample and probability theory to evaluate the sample results. The Department has increasingly relied on statistical sampling in retail sales or use tax audits. Det. No. 02-0114, 22 WTD 174 (2003). While statistical sampling potentially yields greater accuracy and efficiency than block sampling, it may also be more costly.⁷ *Id.* Such sampling must be done on a random, and not on a block, basis. If the number of transactions under audit is large, stratified random sampling can also be used, which stratifies the population into subgroups according to specified attributes, for greater efficiency and accuracy. See Det. No. 10-0386, 32 WTD 71 (2013).

Regardless of the specific method employed, however, sampling is merely a proxy used to derive, as nearly as possible, a taxpayer's true tax liability in any given case over a given time period. That

⁷ The potential differences in accuracy between block and statistical sampling was discussed in Will Yancey & Roger C. Pfaffenberger, *Use and Abuse of Sampling in Sales and Use Tax Audits*, 97 *COST State Tax Report*, Issue 6, pp. 2-9 (November 1997), reprinted in 13 *State Tax Notes* 1673 (December 29, 1997), as follows:

The severe limitation of nonstatistical sampling is that it does not allow the auditor to make a quantitative estimate of sampling risk. An example of nonstatistical sampling is block sampling in which the auditors select a few days or weeks from the population which the auditor or taxpayer deems to be representative of the entire population. By not taking sample transactions over the entire audit period, block samples run the risk of producing sample information that is relevant only to the period for which the sample was taken. If the tax deficiency rate in the sample differs significantly from the population, the block sampling method will produce results that are not valid.

Statistical sampling methods provide a quantitative estimate of the sampling risk. Statistical sampling requires that the person selecting the sample rely on a random sample selection process rather than his or her judgment about the extent to which the sample represents the population. The statistical sample might not be a good representation of the population in some instances, but this sampling risk can be quantified using statistical formulas derived from the theory of probability.

is, some sample portion of a taxpayer's complete records is chosen for examination in an effort to estimate and project what a complete review of those records would have established. Generally, sampling will be used only when a taxpayer and the Department agree to do so. In this case, Compliance declined to accept the use of a sampling method and, instead, assessed tax based on its examination of *all of the records* at its disposal, which, by definition, provides the most accurate measure of the Taxpayer's true tax liability. As Taxpayer provided additional records establishing that certain sales were exempt from retail sales tax, Compliance allowed those exemptions. We are aware of no authority, nor has Taxpayer provided any, that suggests the Department must use a sampling methodology in any particular case. Therefore, we uphold the assessments.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 19th day of July 2018.