

Cite as Det. No. 18-0148, 39 WTD 010 (2020)

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. 18-0148
)	
... )	Registration No. . . .
)	

[1] RULE 186(402); RCW 84.24.030(6); RCW 82.24.120: CIGARETTE TAX AND REMEDIAL PENALTY – RYO CIGARETTES – CIGARETTE TAX STAMPS. The sale of RYO cigarettes without cigarette stamps subjects the cigarettes sold to the cigarette tax and the cigarette remedial penalty.

[2] RCW 84.24.030(6); RCW 82.24.090(1); RCW 82.24.280(3): CIGARETTE TAX – RECORDKEEPING – REASONABLE ESTIMATES. The Department’s estimate of Taxpayer’s sale of RYO cigarettes was reasonable where it was based upon Taxpayer’s testimony of the cartons sold and business records found at Taxpayer’s place of business.

[3] RCW 82.32.090: EVASION PENALTY – INTENT TO EVADE. The Department correctly assessed the evasion penalty where Taxpayer possessed unstamped cigarettes that it had manufactured and Taxpayer was aware that tax was due.

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.

Lewis, T.R.O. – A corporation protests the estimated cigarette tax and penalties imposed on the sale of “roll your own” (“RYO”) cigarettes, asserting that the tax and penalties are not due and, if due, the estimate of sales is too high. Taxpayer’s petition is denied.<sup>1</sup>

ISSUES:

1. Did Taxpayer sell RYO cigarettes without cigarette stamps in violation of RCW 84.24.030(6) and WAC 458-20-186(402), subjecting the cigarettes sold to the cigarette tax and the cigarette remedial penalty?
2. May the Department estimate Taxpayer’s sale of RYO cigarettes under RCW [82.24.280(3)]?

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

3. Did the Department correctly assess the evasion penalty under the provisions of RCW 82.32.090?

#### FINDINGS OF FACT:

On July 22, 2015, the Washington Liquor and Cannabis Board (“LCB”) received a complaint that Taxpayer was manufacturing and selling untaxed RYO cigarettes. Subsequently, the LCB executed a search warrant at Taxpayer’s residence and found: three industrial sized RYO machines, loose tobacco, hollow cigarette tubes, sales, log books, financial documents, purchase invoices, and miscellaneous documents. In a separate office suite, the LCB found sealed boxes of RYO cigarettes, empty tobacco, cigarette tube boxes, and two cash registers. The LCB also found a 2013 planner that contained a RYO sales log. In a previous surveillance, the LCB observed boxes of RYO cigarettes leave the residence.

The results of the LCB investigation were forwarded to the Department of Revenue (“Department”). On March 20, 2017, the Department issued two assessments: Invoice No. . . . – Document No. . . . /Audit No. . . . in the amount of \$ . . . , consisting of \$ . . . in cigarette tax, \$ . . . in interest, \$ . . . in evasion and remedial penalties, and \$ . . . in assessment penalty; and Invoice No. . . . – Document No. . . . /Audit No. . . . in the amount of \$ . . . consisting of \$ . . . in [retail sales tax, \$ . . . in retailing B&O tax, \$ . . . in use tax/deferred sales tax], \$ . . . in interest, a \$ . . . assessment penalty, and \$ . . . in evasion . . . penalties.

Taxpayer had failed to report cigarette tax on its sales even though the Department had issued notice of the requirement to pay tax on RYO cigarettes. On May 25, 2012, the Department issued a notice entitled “Commercial Cigarette-Making Machines Operated at Retail Establishments and the Taxation of Roll-Your-Own Cigarettes.” The notice stated:

Effective July 1, 2012, per 3E2SHB 2565 (Chapter 4, 2012 Laws 1<sup>st</sup> Special Session,) retailers who provide customers with access to a commercial roll-your-own- (RYO) cigarette-making machine are required to provide containers for customers to transport RYO cigarettes from the retailer’s place of business and to affix cigarette tax stamps to each container provided. Cigarette tubes must be provided in one or more 20-unit denominations.

You must have a Cigarette Retailer License, and a Tobacco Products Retailer license to sell cigarettes and loose tobacco, respectively. In addition, after June 30, 2012 you must have an approved Commercial Cigarette Making Machine License to sell RYO cigarettes. The cigarette machine license requires holding a Cigarette Retailer license.

The search of Taxpayer’s business by the LCB revealed that Taxpayer had received a letter from the office of the Attorney General of Washington – Revenue Division, dated May 29, 2012. The letter stated:

This letter is to alert you to recent legislation in Washington State that will impact your obligations as a retailer with a commercial roll-your-own cigarette making machine.

As of July 1, 2012, cigarette tax will be collected by Washington on packs of cigarettes produced with a commercial roll-your-own cigarette machine. *See* 3ESSHB 2565, available at <http://apps.leg.wa.gov>. The collection of this tax affects your obligations under other state laws. Under RCW 70.157, any tobacco used for making cigarettes with commercial roll-your-own cigarette machines will become subject to the requirements in RCW 70.157 and RCW 70.158. Therefore, beginning on July 1, 2012, tobacco manufacturers whose tobacco is sold to Washington RYO cigarette-making retail establishments must become certified by the Attorney General's Office, regardless of how the tobacco is labeled.

As of July 1, 2012, it will be unlawful for a commercial roll-your-own cigarette machine establishment to sell, offer, or possess for sale any tobacco to be purchased by consumers as tobacco for making cigarettes, regardless of its label, unless it appears on the Washington Attorney General's Directory RCW 70.158.030(3); RCW 70.158.010(3); RCW 70.157.010(d). Thus, as of July 2012, if you sell, offer, or possess for sale tobacco for making cigarettes that does not appear on Washington directory, the Attorney General's Office can take enforcement action against you by obtaining an injunction against you or by any other means provided in RCW 70.157 and RCW 70.158, RCW 70.157 and RCW 70.158 can be found at <http://apps.leg.wa.gov/rce>.

The investigation report the Department received from the LCB revealed that Taxpayer was aware of the need to report cigarette tax on the sale of RYO cigarettes. During an LCB interview with Taxpayer, Taxpayer explained that, after learning of the passage of the legislative bill (3E2SHB 2565), which made changes to laws affecting the sale of RYO cigarettes, it continued to manufacture and sell RYO cigarettes as a private club, the . . . . Taxpayer explained that, in the early years of its operation, it sold 400 cartons a month, but sales had later fallen to approximately 30 cartons a month.

Taxpayer disagreed with the assessments. On June 2, 2017, Taxpayer filed petitions requesting the correction of assessments recorded in Invoice . . . and . . . . On June 21, 2017, Taxpayer requested that Invoice No. . . . – BAS . . . in the amount of \$ . . . , consisting of \$ . . . in cigarette tax, and \$ . . . interest, be included as part of the review.

Taxpayer's petition maintained that, for various reasons, no tax was due and that the Department had erred in estimating the amount of tax due. One argument was that it "detrimentally relied" upon information provided by a reputable legal source, advising that [Taxpayer] could operate a tax-exempt "Social Club" under IRC § 501(c)(7) within the State of Washington.

Taxpayer argues the Department should be estopped from assessing tax because Taxpayer believed it did not have to pay tax based on the analysis contained in two memorandums, issued to another company by an out-of-state law firm, which discussed federal tax liability, not state tax liability. The memorandum issued on August 8, 2012, was entitled "Requirements for Tax-Exempt 'Social Clubs' Under IRC § 501(c)(7) – Supplemental Memorandum Addressing Additional Questions." The memorandum, issued on September 13, 2012, was entitled "Tax-Exempt 'Social Clubs' Under

IRC § 501(c)(7) – Guidelines for Operation of a Social Club Within an Existing Retail Tobacco Outlet.” The Department did not author or endorse either memorandum.

During the in-person hearing with Taxpayer, [Taxpayer] did not challenge the tax and penalties assessed. Rather, [Taxpayer’s] concern was with the ability to pay. No information has been presented that Taxpayer sold cigarettes in anything less than full carton amounts.

#### ANALYSIS:

Chapter 82.24 RCW requires a cigarette tax stamp, designed by the Department, to be affixed to the smallest container or package of cigarettes that will be sold, distributed, or consumed. RCW 82.24.030(1). Furthermore, in the case of RYO cigarettes, RCW 82.24.030(6) requires:

In order to enforce collection of the tax in the case of roll-your-own cigarettes, a retailer must affix a stamp or stamps to each box or similar container provided by the retailer to the consumer. The box or similar container must be used by a consumer to transport roll-your-own cigarettes from the retailer's place of business. A retailer must provide cigarette tubes to a consumer in one or more twenty unit denominations. Stamps must be for an amount equaling the tax due under this chapter. Each cigarette tube or paper provided to the consumer is deemed a cigarette for purposes of imposing and collecting taxes under this chapter. Stamps for roll-your-own cigarettes must be issued and affixed in a manner determined by the department but as consistent as practicable with the stamping requirements for wholesalers.

WAC 458-20-186(402) (“Rule 186”) echoes RCW 82.24.030(6):

**Stamps.** Retailers of roll-your-own cigarettes must purchase and affix roll-your-own cigarette tax stamps for the cigarettes produced through the cigarette making machine. Retailers must contact the department's special programs division to purchase the stamps. Stamps affixed must be for an amount equaling the cigarette tax due. Each cigarette tube or paper provided to the consumer is deemed a cigarette for purposes of imposing and collecting the cigarette tax. Stamps must be of the type authorized by the department and affixed in the manner provided for wholesalers in subsection (301) (a) of this rule. Retailers purchasing stamps for roll-your-own cigarettes are compensated for affixing the stamps with the stamping allowance provided under subsection (301)(b) of this rule, as well as an additional amount of five cents per cigarette to offset the cost of the tobacco products tax under chapter 82.26 RCW and WAC 458-20-185. See RCW 82.24.030(6) for additional rules relating to the affixing of stamps for roll-your-own cigarettes.

Unstamped cigarettes are subject to a remedial penalty. RCW 82.24.120 provides:

(1) If any person, subject to the provisions of this chapter or any rules adopted by the department of revenue under authority of this section, is found to have failed to affix the stamps required, or to have them affixed as provided in this section, or to pay any tax due under this section, or to have violated any of the provisions of this chapter or rules adopted by the department of revenue in the administration of this chapter, there must be assessed

and collected from such person, in addition to any tax that may be found due, a remedial penalty equal to the greater of ten dollars per package of unstamped cigarettes or ten dollars per twenty roll-your-own cigarettes, or two hundred fifty dollars, plus interest on the amount of the tax at the rate as computed under RCW 82.32.050(2) from the date the tax became due until the date of payment, and upon notice mailed to the last known address of the person or provided electronically as provided in RCW 82.32.135. The amount is due and payable in thirty days from the date of the notice. If the amount remains unpaid, the department or its duly authorized agent may make immediate demand upon such person for the payment of all such taxes, penalties, and interest.

(2) The department, for good reason shown, may waive or cancel all or any part of the penalties imposed, but the taxpayer must pay all taxes due and interest thereon, at the rate as computed under RCW 82.32.050(2) from the date the tax became due until the date of payment.

(3) The keeping of any unstamped articles coming within the provisions of this chapter is prima facie evidence of intent to violate the provisions of this chapter.

RCW 82.24.120(1)-(3). Under the law, which the Department administers, a remedial penalty must be assessed even where no tax is due. Taxpayer does not challenge that it manufactured RYO cigarettes and that they were not stamped. We thus find that the remedial penalty was correctly assessed.

Taxpayer requested review of the assessments, maintaining that the Department should be estopped from assessing tax because it believed it did not have to pay tax based on the analysis contained in two memorandums. There is no legal authority for preventing the Department from assessing tax based on advice taxpayers receive from third parties. Furthermore, Taxpayer's argument is not persuasive in light of two facts: 1) the memorandums Taxpayer relied on were issued by a law firm to another business, and 2) the topic addressed was federal tax liability, not state tax liability.

RCW 82.32A enumerates Taxpayer's rights and responsibilities. RCW 82.32A.020 provides:

The taxpayers of the state of Washington have:

The right to rely on specific, official written advice and written tax reporting instructions from the department of revenue to that taxpayer, and to have interest, penalties, and in some instances, tax deficiency assessments waived where the taxpayer has so relied to their proven detriment. . . .

RCW 82.32A.020 (2). In this case, the two memorandums were not issued by the Department, to Taxpayer, and did not discuss state tax liability. . . . We find Taxpayer's argument that it followed tax reporting information from a private source unpersuasive, as taxpayers [may] rely [only] on specific written advice from the Department. *Id.*

Taxpayer also argued that it need not comply with the tax reporting brought about by the law change because it was “grandfathered in” under prior RYO law . . . . [But,] Taxpayer has not provided, nor are we aware of, any prior rulings or laws where a taxpayer was allowed to report tax under an “old” law because it was “grandfathered in.” [In addition, prior to the new law becoming effective, on May 29, 2012, the Attorney General’s Office sent a notice to Taxpayer informing it of a law change and how affected taxpayers should report their tax liability.]

Taxpayer also argued that the assessments violate the Washington constitution. Statutes are presumed constitutional. *Higher Educ. Facilities Auth. v. Gardner*, 103 Wn.2d 838, 843, 699 P.2d 1240 (1985). An administrative agency lacks the power to determine the constitutionality of statutes enacted by the state Legislature. *High Tides Seafoods v. State*, 106 Wn.2d 695, 725 P.2d 411 (1986). A party challenging a statute has to prove the invalidity of the statute beyond a reasonable doubt. *Id.* Taxpayer provides no persuasive legal authority to show that the Department’s taxation of Taxpayer is inconsistent with the plain meaning of the Washington statutes. Taxpayer’s petition is denied on this issue.

Taxpayer also argued that the state was aware that Taxpayer was selling untaxed RYO cigarettes for a substantial time and did not mitigate damages by contacting Taxpayer sooner. Again, Taxpayer provides no legal authority to show the Department had a duty to contact Taxpayer sooner than it did. There is also no evidence in the record that either the LCB or the Department had knowledge that Taxpayer was selling untaxed RYO cigarettes before July 22, 2015, the date the LCB received a complaint about Taxpayer. Taxpayer’s petition is denied as to this issue.

Taxpayer has also challenged the estimate of the amount of tax owing. The Department estimated the total number of packs of untaxed cigarettes sold based on purchase invoices of hollow cigarette tubes obtained at Taxpayer’s residence. RCW 82.24.030 explains the requirement of tax stamps on RYO cigarettes:

(6) In order to enforce collection of the tax in the case of roll-your-own cigarettes, a retailer must affix a stamp or stamps to each box or similar container provided by the retailer to the consumer. The box or similar container must be used by a consumer to transport roll-your-own cigarettes from the retailer's place of business. A retailer must provide cigarette tubes to a consumer in one or more twenty unit denominations. Stamps must be for an amount equaling the tax due under this chapter. Each cigarette tube or paper provided to the consumer is deemed a cigarette for purposes of imposing and collecting taxes under this chapter. Stamps for roll-your-own cigarettes must be issued and affixed in a manner determined by the department but as consistent as practicable with the stamping requirements of wholesalers.

RCW 82.24.030(6).

The Department used the number of cigarette tubes purchased as a basis for estimating Taxpayer’s cigarette tax liability. The Department’s estimate of . . . 14,353 untaxed cartons sold during the audit period, which averages 276 cartons per month, was consistent with: the number of cigarette tubes purchased, Taxpayer’s estimate of sales between 30 and 400 cartons a month, and the Department’s review of Taxpayer’s sales logs.

RCW 82.24.090(1) requires retailers of cigarettes to “keep and preserve for a period of five years an accurate set of records.” *See also* WAC 458-20-186(701). RCW 82.24.280(3) provides, “[i]f upon examination of any returns or from other information obtained from the department it appears that a tax or penalty has been paid less than that properly due, the department shall assess against the taxpayer such additional amount found to be due.” Here, based on the information obtained from LCB, the Department issued an assessment of cigarette tax and remedial penalty that it determined was due.

We have previously held that the Department may make “reasonable” estimates. Det. No. 15-0350, 35 WTD 291 (2016). We have previously held that an estimate based on a thorough review of the available records and other available information constituted a “reasonable” estimate. *Id.* Here, the Department based its estimate on Taxpayer’s testimony of the cartons sold to the LCB, and business records found at Taxpayer’s place of business. Accordingly, we affirm the assessment of [taxes and] penalties as originally issued.

Finally, we find the evasion penalty was correctly assessed. The Department is required to add a fifty percent evasion penalty to a tax assessment when it finds an intent to evade the tax. RCW 82.32.090(7). A taxpayer evades a tax when it (1) “knows a tax liability is due” and (2) “attempts to escape detection through deceit, fraud, or other intentional wrongdoing.” WAC 458-20-230(4)(“Rule 230”).

The Department must show intent to evade “by clear, cogent, and convincing evidence which is objective and credible.” Rule 230(4). In determining intent, the Department must show that the taxpayer deliberately acted with the specific purpose of escaping a tax liability which the taxpayer knew to exist. Det. No. 13-0329, 33 WTD 156 (2014). Although the subjective intent of a person is difficult to ascertain, it may be determined from objective facts, such as the actions or statements of the taxpayer. *Id.* Intent to evade does not exist where a deficiency was due to an honest mistake, miscommunication, or lack of knowledge regarding proper accounting methods. WAC 458-20-228(5)(f). Just as an intent to evade tax exists when a taxpayer willfully fails to remit to the Department the retail sales taxes collected from customers, under WAC 458-20-228(5)(f)(ii)(B), similarly, RCW 82.24.120(3) provides that the keeping of unstamped cigarettes is *prima facie* evidence of an intent to evade the cigarette tax.

That is the case here. Taxpayer not only possessed unstamped cigarettes that it had manufactured, but by Taxpayer’s officer’s own admission, Taxpayer was aware that tax was due. The Department has clearly demonstrated the existence of each of the elements of evasion. While the burden is on the taxpayer to come forward with evidence of honest mistake, ignorance of the law, negligence, or some other fact which would rebut the Department’s evidence, nothing has been presented. 33 WTD 156. We find that the two required elements for the assessment of the evasion penalty are satisfied.

#### DECISION AND DISPOSITION:

Taxpayer's petition is denied.

Dated this 1st day of June 2018.