

Cite as Det. No. 18-0252, 39 WTD 145 (2020)

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

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| 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. 18-0252 |
|) | |
| ...) | Registration No. . . . |
|) | |

[1] RULE 254; RCW 82.32.100: RETAIL SALES TAX – RETAILING B&O TAX –RECORDKEEPING – REASONABLE ESTIMATES. Faced with a taxpayer’s repeated failure to provide a comprehensive set of records to establish with certainty its income over the audit period, the Department acted reasonably when it estimated the taxpayer’s gross income based on the information at its disposal.

[2] RULE 17001; RCW 82.04.050(12): USE TAX/DEFERRED SALES TAX – GOVERNMENT CONTRACTING – FANNIE MAE. A taxpayer engaged in construction projects on behalf of the Federal National Mortgage Association (Fannie Mae) was liable for use/deferred sales tax on purchases the taxpayer made in furtherance of these projects. Although not a federal agency, Fannie Mae is a government instrumentality, exempt, with the sole exception of real property taxes, from all state taxation by act of Congress.

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. – A . . . construction company contests an assessment, arguing the assessment is based on inaccurate and incomplete information, and wrongly reclassified expenditures made in furtherance of non-governmental projects as government contracting expenses for purposes of the use tax/deferred retail sales tax. We deny the petition.¹

ISSUES

1. Whether, under RCW 82.32.070, Taxpayer has produced documentation to establish that the Department’s Audit Division erred when calculating Taxpayer’s gross income.
2. Whether, under [RCW 82.04.050(12) and] WAC 458-20-17001 [(Rule 17001)], the Department incorrectly assessed use tax/deferred retail sales tax on expenditures Taxpayer

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

made in furtherance of construction projects on behalf of the Federal National Home Mortgage Association in Washington.

FINDINGS OF FACT

. . . (Taxpayer) is a . . . Washington based construction company that performs a significant portion of its work on behalf of the Federal National Mortgage Association (Fannie Mae), both within and without this state.

In May 2016, the Department's Audit Division (Audit) notified Taxpayer of the Department's intent to commence, the following January, an examination of Taxpayer's books and records, covering the period January 1, 2013 through December 31, 2016. At the initial field meeting in January 2017, Audit discussed with Taxpayer the nature of its business and requested a host of documents, including, among other things, Taxpayer's federal tax returns, profit and loss statements (P&Ls), and bank statements. When the Taxpayer stated that it had lost its sales data for 2013 and 2014, Audit requested Taxpayer's QuickBooks data. Though Taxpayer also claimed to have lost much of its original QuickBooks data, Taxpayer stated it was in the process of recreating that data, and provided Audit with incomplete bank records from seven different bank accounts, along with certain invoices and additional records. Although Taxpayer did later provide Audit with reconstructed QuickBooks records for 2015 and 2016, and claimed to have issued its invoices through that program, Audit noted that the numbers on previously provided invoices differed from the invoice numbers set forth in the QuickBooks sales data. When asked about this discrepancy, Taxpayer stated that, on occasion, it issued invoices through Excel and only later added them to QuickBooks.

Over the next several months, Audit attempted, repeatedly, to gather from Taxpayer records sufficient to piece together an accurate view of Taxpayer's income during the audit period. Finally, noting that, based on information at its disposal, which appeared to approximate income amounts on Taxpayer's federal tax returns, Audit, in July 2017, sent Taxpayer a copy of its preliminary findings.

When Taxpayer disagreed with these findings, Audit scheduled a meeting with Taxpayer and Taxpayer's representative. At this meeting, Taxpayer informed Audit that it believed it now possessed complete QuickBooks data for 2013 and 2014. However, when the Taxpayer failed to provide this, or any further documentation, Audit closed its investigation in August 2017, and finalized its assessment on September 14, 2017. This assessment included unpaid retail sales tax, use tax, and business and occupation (B&O) tax in the retailing classification.

Shortly thereafter, Taxpayer requested a post-assessment adjustment. Audit agreed to consider the request and allowed Taxpayer a sixty-day extension to provide further documentation. Near the end of the extension period, Taxpayer provided bank statements for 2013 and 2014 along with evidence of certain checking account deposits. In addition, Taxpayer provided QuickBooks online data. Upon examination of this data, however, Audit discovered that, although Taxpayer had previously provided "reconstructed" data for 2015 and 2016 during the initial examination, now only data for 2017, a period outside of the audit timeframe, was available. When Audit made

inquiry with Taxpayer regarding this anomaly, Taxpayer informed Audit that none of its prior QuickBooks data was accessible.

On December 14, 2017, Audit scheduled another meeting with Taxpayer to discuss various issues. At this meeting, Taxpayer attempted to put into context the bank statements and check deposits it had provided earlier in the week. Taxpayer also stated its belief that it had over reported its income on its federal tax returns for 2013 and 2014 and announced an intention to file amended returns for those years. Audit agreed to review the amended returns and urged Taxpayer to complete and file them as soon as possible.

Two weeks later, Taxpayer provided Audit copies of amended IRS returns for the years at issue. Taxpayer, however, failed to provide confirmation that these returns had been filed with, or accepted by, the IRS. When Audit questioned Taxpayer about the absence of such confirmation, Taxpayer represented that, since federal offices were closed, the amended returns had not yet been filed.

A final meeting was held to discuss errors Audit located in the amended returns and issues in connection with bank statements and deposits Taxpayer had recently provided. Following this meeting, Audit again determined that the various documentation Taxpayer had provided established that Taxpayer's income closely approximated the income it earned in years 2014, 2015, and 2016, and reported on its original federal tax returns, and issued the following assessment:

| | 2013 | 2014 | 2015 | 2016 | Total |
|----------------------------|--------|--------|--------|--------|--------|
| Retail Sales Tax | \$... | \$... | \$... | \$... | \$... |
| Retailing B&O Tax | \$... | \$... | \$... | \$... | \$... |
| Use Tax\Deferred Sales Tax | \$... | \$... | \$... | \$... | \$... |
| Interest | \$... | \$... | \$... | \$... | \$... |
| 5% TAS Penalty | | | | \$... | \$... |
| Total | \$... | \$... | \$... | \$... | \$... |

Taxpayer then timely petitioned us for review of the assessment. In support of its petition, Taxpayer makes two primary arguments. First, Taxpayer asserts that Audit's assessment is incorrect and based on faulty bookkeeping. Specifically, Taxpayer disputes the assessment of retail sales tax on differences between gross amounts reported on Taxpayer's 2013 and 2014 federal tax returns and the amounts listed on its Washington excise tax returns. Second, Taxpayer argues that, since Fannie Mae is not a government agency, Taxpayer should not be responsible for sales tax on purchases it made in connection with its Washington Fannie Mae work.

Taxpayer's representative submitted several emails containing bank records for certain accounts in April 2018, some of which had not been provided to Audit. On June 26, 2018, we held an in-person hearing in Tumwater, Washington, at which Taxpayer's representative appeared. At the hearing, we informed Taxpayer's representative that we would close the record in 30 days. On the 30th day, Taxpayer's representative submitted additional documentation and, following the close of the record on August 15, submitted copies of amended federal tax returns for 2013 and 2014. Again, however, Taxpayer has failed to provide any evidence that it actually filed these returns with the Internal Revenue Service.

ANALYSIS

1. Recordkeeping Requirements

RCW 82.32.070 provides:²

(1) Every person liable for any fee or tax imposed by chapters 82.04 through 82.27 RCW shall keep and preserve, for a period of five years, suitable records as may be necessary to determine the amount of any tax for which he may be liable, which records shall include copies of all federal income tax and state tax returns and reports made by him. All his books, records, and invoices shall be open for examination at any time by the department of revenue.

In cases in which a taxpayer fails to keep and preserve suitable records, RCW 82.32.100 states:

(1) If any person fails or refuses to make any return or to make available for examination the records required by this chapter, 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; and to this end the department may examine the records of any such person as provided in RCW 82.32.110.

In this case, despite multiple Audit requests, Taxpayer was unable at any point during the initial examination, or thereafter, to provide a comprehensive set of records to establish with certainty its income over the audit period. Furthermore, there are indications calling into question the reliability of Taxpayer's records. While the Taxpayer, for example, asserts that these records are contemporaneous and were generated throughout the audit period, some of this detail was not offered during the course of the original audit examination, but rather produced during Audit's investigation and this review. Regardless when these records were created, however, the records themselves contain neither an explanation, nor any detail, as to what source records support these figures, nor a representative showing of any source documentation to substantiate these numbers for the audit period is included.³

We therefore affirm Audit's assessment in connection with this issue in its entirety.

² This provision was amended in the middle of the audit period by Laws of 2015, Chapter 86, Sec. 310, as part of a technical corrections bill, and currently reads:

(1) 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. . . .

³ Now, in connection with this appeal, Taxpayer has provided additional bank records in connection with hitherto undisclosed bank accounts. Taxpayer has also submitted what it again claims are amended federal tax returns for 2013 and 2014. Yet, again, Taxpayer has failed to provide confirmation that the amended returns were ever filed. We further note in this regard that, despite a purported lower gross income total, no refund was claimed on these amendments. Finally, it bears mention that the statute of limitations for filing amended federal tax returns for years 2013 and 2014 has passed.

2. Fannie Mae

Washington imposes a retail sales tax on all “retail sales” under Chapter 82.08 RCW. “Retail sale” is defined in RCW 82.04.050 and includes sales of tangible personal property and certain services, including, for example, “services rendered in respect to . . . [t]he constructing, repairing, decorating, or improving of new or existing buildings or other structures under, upon, or above real property of or for consumers” RCW 82.04.050(2)(b). “Retail sale,” however, specifically excludes:

[T]he sale of or charge made for labor and services rendered in respect to the constructing, repairing, decorating, or improving of new or existing buildings or other structures under, upon, or above real property of or for the United States, any instrumentality thereof, or a county or city housing authority created pursuant to chapter 35.82 RCW, including the installing, or attaching of any article of tangible personal property therein or thereto, whether or not such personal property becomes a part of the realty by virtue of installation. Nor does the term include the sale of services or charges made for the clearing of land and the moving of earth of or for the United States, any instrumentality thereof, or a county or city housing authority. Nor does the term include the sale of services or charges made for cleaning up for the United States, or its instrumentalities, radioactive waste and other by-products of weapons production and nuclear research and development.

RCW 82.04.050(12). In such cases, the contractor or subcontractor providing these services is defined as the consumer of the tangible personal property which is installed, applied, attached, or otherwise incorporated in their government contracting work. RCW 82.04.190(6).⁴

. . . Rule 17001 is the Department’s administrative rule addressing government contracting as applied to the construction, installation, or improvement of real property owned by, or on behalf of, the federal government. Specifically, the rule addresses the application of three types of Washington tax on such activities. First, in addressing B&O tax, the rule states:

Amounts derived from constructing, repairing, decorating, or improving new or existing buildings or other structures, including installing or attaching tangible personal property therein or thereto, and clearing land or moving earth, of or for the United States, its instrumentalities, or county or city housing authorities of chapter 35.82 RCW are taxable under the government contracting classification of business and occupation tax. The measure of the tax is the gross contract price.

Rule 17001(3). In addressing the exclusion of sales to the federal government from retail sales tax, Rule 17001(5) explains the government contractor’s sales tax liability for its purchases of materials:

⁴ Specifically, RCW 82.04.190(6) states that:

Any person engaged in the business of constructing, repairing, decorating, or improving new or existing buildings or other structures under, upon, or above real property of or for the United States, any instrumentality thereof, or a county or city housing authority . . . is a consumer within the meaning of this subsection in respect to tangible personal property incorporated into, installed in, or attached to such building or other structure by such person . . .

The retail sales tax does not apply to the gross contract price, or any part thereof, for any business activities taxable under the government contracting classification. Prime and subcontractors who perform such activities are themselves included within the statutory definition of “consumer” under RCW 82.04.190 and are required to pay retail sales tax upon all purchases of materials, including prefabricated and precast items, equipment, and other tangible personal property which is installed, applied, attached, or otherwise incorporated in their government contracting work. This applies for all such purchases of tangible personal property for installation, etc., even though the full purchase price of such property will be reimbursed by the government or housing authority in the gross contract price. It also applies notwithstanding that the contract may contain an immediate title vesting clause which provides that the title to the property vests in the government or housing authority immediately upon its acquisition by the contractor.

Finally, in addressing the applicability of Washington’s use tax, which complements the retail sales tax, the rule in part states:

(7) The use tax applies upon the value of all materials, equipment, and other tangible personal property purchased at retail, acquired as a bailee or donee, or manufactured or produced by the contractor for commercial or industrial use in performing government contracting and upon which no retail sales tax has been paid by the contractor, its bailor or donor.

(8) Thus the use tax applies to all property provided by the federal government to the contractor for installation or inclusion in the contract work as well as to all government provided tooling.

(9) The use tax is to be reported and paid by the government contractor who actually installs or applies the property to the contract. Where the actual installing contractor pays the tax, no further use tax is due upon such property by any other contractor.

Rule 17001(7) – (9). In this case, Audit assessed use tax/deferred sales tax against the cost of materials purchased by Taxpayer for attachment or incorporation into the Fannie Mae owned or controlled buildings and structures. Taxpayer, however, argues that, since Fannie Mae is not a government agency, but rather a private insurance agency, Taxpayer should not be liable for this tax.

[W]ith the exception of real property taxes, both [Fannie Mae and the Federal Home Loan Mortgage Corporation (Freddie Mac)] are [government instrumentalities, which are] exempt from state taxation by act of Congress. Indeed, Fannie Mae’s founding document, the Federal National Mortgage Association Charter Act,⁵ specifically states:

The corporation, including its franchise, capital, reserves, surplus, mortgages, or other security holdings, and income shall be exempt from taxation now or hereafter imposed by any State, territory, possession, Commonwealth, of dependency of the

⁵ Congress founded Fannie Mae in 1938 as part of the New Deal with the express purpose of providing stability in the secondary mortgage market. *See* Federal National Mortgage Association Charter Act, ch. 847, title III, 48 Stat. 1254 (codified as amended at 12 U.S.C. §§ 1716-1723i (2018)).

United States, or by the District of Columbia, or by any county, municipality, or local taxing authority, except that any real property of the corporation shall be subject to State, territorial, county, municipality, or local taxation to the same extent as other real property is taxed.

12 U.S.C. § 1723(c)(2). [*See also, Hennepin County v. Federal Nat. Mortg. Ass'n*, 742 F.3d 818 (8th Cir. 2014)(stating that “no question remains that Fannie Mae, Freddie Mac and the [Federal Housing Finance Agency] are governmental instrumentalities which Congress has the authority to protect by exempting them from taxation imposed by the states”).]

Since Taxpayer is, therefore, subject to use tax/deferred sales tax on expenditures it made in furtherance of its Fannie Mae construction projects in Washington, we affirm Audit’s findings in connection with this issue in their entirety, as well.

DECISION AND DISPOSITION

The taxpayer’s petition is denied.

Dated this 20th day of September 2018.