

Cite as Det. No. 14-0072, 36 WTD 315 (2017)

BEFORE THE APPEALS 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. 14-0072
)	
...)	Registration No.
)	

[1] RULE 254; RCW 82.32.070; RCW 82.32.100: RETAIL SALES TAX – RETAILING B&O TAX – RECORDKEEPING – REASONABLE ESTIMATES. Where a taxpayer has failed to maintain adequate records upon which the Department is able to determine the taxpayer’s tax liability, the Department is required to estimate the taxpayer’s tax liability based on the facts and information available.

[2] RULE 228; RCW 82.32.090: RETAIL SALES TAX – EVASION PENALTY – INTENT TO EVADE. Evidence that a taxpayer substantially underreported income, failed to maintain records properly documenting its income previously remitted retail sales tax to the Department, and was aware of its tax liability, establishes intent to evade.

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, A.L.J. – A grocery store business protests an assessment of retail sales tax, retailing business and occupation (B&O) tax, and evasion penalty, asserting that the auditor overestimated its retail sales based on its bank records and that it did not intentionally underreport its tax liability. The taxpayer’s petition is denied.¹

ISSUES

1. Whether the Department of Revenue appropriately estimated the taxpayer’s tax liability because of the taxpayer’s lack of reliable records, pursuant to RCW 82.32.100 and WAC 458-20-254.
2. Whether the taxpayer is liable for an evasion penalty assessed for unpaid tax liability, pursuant to RCW 82.32.090(7).

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

FINDINGS OF FACT

[Taxpayer] operates a grocery store in [Washington]. The Department of Revenue (the Department), Audit Division, reviewed the taxpayer's records for excise tax purposes for the period January 1, 2008, through March 31, 2012. The taxpayer informed the auditor that all of its business records were destroyed by water damage caused by a flood in In addition, the taxpayer indicated that it did not have register receipts because its cash register had recently been stolen and it had not yet programmed its new register. The taxpayer provided to the auditor its available records, including bank statements, federal tax returns, and purchase journals for January through March 2012.

The auditor used the taxpayer's available records to determine its excise tax liability. The taxpayer indicated to the auditor that it used its bank accounts for both business and personal purposes, and that many deposits were non-business related. Of the \$. . . in total deposits for the audit period, the auditor excluded deposits of \$. . . that could be verified as non-business income. The taxpayer's purchases log for January through March 2012, showed cash purchases of approximately \$. . . , whereas bank statements for the same three-month period showed deposits of approximately \$. . . (net of retail sales tax and non-business deposits). The cash purchases log and the bank statements evidenced that a large portion of the taxpayer's income was used to make cash purchases, and only 15 percent of income was deposited in its bank accounts. The taxpayer's federal tax returns showed income exceeding the amounts reported on excise tax returns.

In order to reconcile the amounts reported on the taxpayer's excise tax returns with the limited records provided by the taxpayer, the auditor used the bank statements and purchase journals for January through March 2012, to determine estimated sales. A monthly average of cash purchases was determined for the sample period of January through March 2012, multiplied by the number of months under audit, and added to the bank deposits, resulting in estimated retail sales for the audit period of \$ For retailing B&O tax purposes, the taxpayer reported \$. . . for the audit period. To determine retail sales tax liability for the audit period, a percentage of exempt foods deduction was calculated and applied to the total sales, resulting in estimated retail sales subject to retail sales tax of \$ For retail sales tax purposes, the taxpayer reported sales of \$. . . for the four-year audit period. The retail sales amounts the taxpayer reported on its excise tax returns were substantially lower than the amounts represented by the taxpayer's available records. As a result, an assessment was issued against the taxpayer for retail sales tax, retailing B&O tax, interest, and penalties, for a total amount of \$

The taxpayer appealed the assessment, asserting that the auditor failed to exclude non-business income from deposits, overestimated cash payouts for purchases, and erred in applying the evasion penalty because the taxpayer did not intentionally underreport its tax liability.

At the hearing, the taxpayer provided profit and loss statements it prepared for the period July through September 2013, and asserted that the retail sales amount for this three-month period are representative of its sales throughout the audit period, and that this amount should be used in computing its tax liability. The taxpayer also provided copies of IRS 1099 forms it received from money wiring services as evidence of the taxpayer's commission income from these services during the audit period, and asserted that these amounts should be used to reduce the amount of

taxable retail sales included in the assessment. When asked whether the taxpayer's bank statements could verify the transactions with the money wiring services and commission amounts deposited, the taxpayer indicated "that was not always the case." The taxpayer did not provide evidence that the auditor included amounts related to its money wiring services in the measure of retail sales used as a basis for the assessment. The Audit Division declined to make any adjustment to the assessment based on the additional records provided.

ANALYSIS

Recordkeeping and estimated tax liability.

A taxpayer has the responsibility to maintain suitable records as may be necessary for the Department to determine the taxpayer's tax liability, as provided by RCW 82.32.070(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.

The Department's rule implementing RCW 82.32.070(1), WAC 458-20-254 (Rule 254), is specific as to the types of documents taxpayers must maintain, and includes the following:

(3) Recordkeeping requirements -- General.

(a) Every taxpayer liable for a tax or fee imposed by the laws of the state of Washington for which the department of revenue has primary or secondary administrative responsibility . . . must keep complete and adequate records from which the department may determine any tax liability for such taxpayer.

(b) It is the duty of each taxpayer to prepare and preserve all records in a systematic manner conforming to accepted accounting methods and procedures. Such records are to be kept, preserved, and presented upon request of the department or its authorized representatives which will demonstrate:

(i) The amounts of gross receipts and sales from all sources, however derived, including barter or exchange transactions, whether or not such receipts or sales are taxable. These amounts must be supported by original source documents or records including but not limited to all purchase invoices, sales invoices, contracts, and such other records as may be necessary to substantiate gross receipts and sales.

(ii) The amounts of all deductions, exemptions, or credits claimed through supporting records or documentation required by statute or administrative rule, or other supporting records or documentation necessary to substantiate the deduction, exemption, or credit.

...

(c) The records kept, preserved, and presented must include the normal records maintained by an ordinary prudent business person. Such records may include general ledgers, sales journals, cash receipts journals, bank statements, check registers, and purchase journals, together with all bills, invoices, cash register tapes, and other records or documents of original entry supporting the books of account entries. The records must include all federal and state tax returns and reports and all schedules, work papers, instructions, and other data used in the preparation of the tax reports or returns.

...

(4) Record retention period. All records must be open for inspection and examination at any time by the department, upon reasonable notice, and must be kept and preserved for a period of five years. RCW 82.32.070.

Rule 254(3)(a)-(c) and (4).

If any person fails or refuses to make records available for examination, RCW 82.32.100(1) authorizes the Department to proceed, “in such manner as it may deem best, to obtain facts and information on which to base its estimate of the tax.” Once the Department obtains the facts and information, the Department “shall proceed to determine and assess against such person the tax and any applicable penalties or interest due.” RCW 82.32.100(2).

In the present case, the taxpayer contends that the auditor erred in failing to exclude from the measure of taxable retail sales non-business bank deposits representing personal loans and commissions from money wiring services. In addition, the taxpayer asserts that the amounts of retail sales it compiled for a recent 2013 period should be used as the estimated measure of its taxable retail sales, rather than the estimated average determined by the auditor. The taxpayer has not provided adequate documentation to substantiate its assertions. A taxpayer is required to document all non-income deposits for purposes of reconciling taxable income with reported income. Det. No. 12-0277, 32 WTD 194, 196 (2013) (*citing* Det. No. 10-0167, 30 WTD 89 (2011)). Where a taxpayer has failed to fulfill its duty in maintaining adequate records, thereby necessitating a projection based on records that are available, it may not then successfully argue that a sample period projection of income is unrepresentative. Det. No. 95-138, 16 WTD 33, 36 (1995).

Here, the taxpayer did not maintain suitable records upon which the Department was able to determine the taxpayer’s tax liability, as required by RCW 82.32.070(1) and Rule 254. As a result, the auditor was required to estimate the taxpayer’s tax liability based on the facts and information available, pursuant to RCW 82.32.100. The auditor was justified in using the taxpayer’s bank deposits in conjunction with its purchase logs to estimate gross income. *See* 32 WTD at 196. The auditor is the person who has the opportunity to look at the taxpayer’s various records. As the Department recently stated in 32 WTD 194: “[a Department] auditor is particularly qualified by training and experience to determine which records are suitable for determining the amount of tax due. We generally will not second-guess the auditor’s decision as to which records should be used

for determining whether the taxpayer has correctly and completely reported.” 32 WTD at 196. The taxpayer’s petition is denied on this issue.

Evasion penalty.

RCW 82.32.090(7) provides that “[i]f the department finds that all or any part of the deficiency resulted from an intent to evade the tax payable hereunder, a further penalty of fifty percent of the additional tax found to be due *must* be added.” (Emphasis added.)

To impose the evasion penalty, the Department must prove: (1) a tax liability that the taxpayer knows is due; and (2) an attempt by the taxpayer to escape detection through deceit, fraud, or other intentional wrongdoing. *See, e.g.*, Det. No. 03-0147, 22 WTD 274, 276 (2003); Det. No. 98-065, 17 WTD 359, 369-370 (1998); Det. No. 94-007, 14 WTD 174, 177 (1995); WAC 458-20-228(5)(f) (Rule 228(5)(f)). The Department has the burden of proving both elements of evasion by clear, cogent, and convincing evidence. *Id.* Clear, cogent, and convincing evidence has been described as evidence convincing the trier of fact that the fact in issue is “highly probable,” or, stated another way, the evidence relied upon must be “clear, positive and unequivocal in [its] implication.” *Colonial Imports, Inc. v. Carlton Northwest, Inc.*, 121 Wn.2d 726, 735, 853 P.2d 913 (1993).

To meet this burden, the Department must present objective and credible evidence that clearly demonstrates intent to evade a known tax liability; mere suspicion of intent to evade is not enough to meet this burden. 22 WTD at 276. “Intent is a state of mind. As such, it must usually be proved by circumstantial evidence.” *State v. LaRue*, 5 Wn. App. 299, 306, 487 P.2d 255 (1971). Circumstantial evidence of intent may be gathered from the outward manifestations of the person entertaining it, and the facts or circumstances surrounding the alleged offense. *State v. Gaul*, 88 Wash. 295, 301, 152 P. 1029 (1915); *see* Det. No. 04-0098, 23 WTD 331, 338 (2004).

Mere underreporting of collected retail sales tax does not constitute evasion. *See* Det. No. 98-065, 17 WTD 359, 371 (1998) (evasion not found where the taxpayer claimed underreporting was due to dishonest bartenders). However, substantial underreporting of collected retail sales tax does constitute evasion. *See* Det. No. 97-134R, 18 WTD 163, 167 (1999) (evasion found where the taxpayer filed “no business” returns when it had gross receipts and also failed to remit collected retail sales tax). Similarly, failing to provide access to tax records and failing to file excise tax returns unless pressured by the Department demonstrates evasion. *See* Det. No. 97-238, 18 WTD 215, 218-219 (1999) (evasion found where the taxpayer claimed records were out of state and entered into contracts that stated “retail sales tax” is included, but failed to report the collected retail sales tax).

Once the Department has clearly demonstrated the existence of [an intent to evade], a . . . taxpayer [can overcome the imposition of the evasion penalty] with evidence [that the deficiency resulted from a] honest mistake, [miscommunication, or lack of knowledge of proper accounting methods]. Rule 228(5)(f). Mere subjective and self-serving statements by the taxpayer . . . , without more, are insufficient to [overcome a finding of an intent to evade. 23 WTD at 338.]

Here, the first element required to impose the evasion penalty is met. The facts show that the taxpayer was aware of its tax liabilities based on its history of reporting income, paying tax, and remitting collected retail sales tax.

The second element required to impose the evasion penalty is also met. The facts show that the taxpayer attempted to escape payment of its tax liability by dishonestly, substantially underreporting retail sales during the audit period. Although an intent to evade does not exist where a tax deficiency is the result of an honest mistake, miscommunication, or the lack of knowledge regarding proper accounting methods, we do not find that to be the case here. *See* Rule 228(5)(f). The taxpayer's bank and purchase records evidence a substantial amount of income that was not reported. The taxpayer reported greater amounts of income on its federal tax returns than it reported on its excise tax returns. The taxpayer's selective underreporting of its income on its excise tax returns evidences its intent to misrepresent its taxable income and avoid paying taxes due.

The taxpayer's assertions that it fully reported its tax liability and that the auditor overestimated its retail sales, as addressed above, are not substantiated and not credible in light of the objective evidence. Though the taxpayer's loss of records is asserted to have been caused by flood and theft, the taxpayer failed to maintain *any* records of sales following the loss of these records, even though it did maintain and provide the auditor with a purchases log for the three-month period of January through March 2012. The taxpayer's failure to maintain any sales records, particularly in light of the fact that it had just lost all of its records, calls into question its assertions regarding its recordkeeping and purported accurate reporting of its excise tax liabilities. Rather, the objective evidence shows that the taxpayer intentionally underreported its sales on its excise tax returns.

Federal courts have upheld the federal civil tax fraud penalty, 26 USC § 6663 (IRC § 6663),² under circumstances similar to those here, involving substantial underreporting of income over a number of years, overstated deductions, inadequate records, large cash expenditures, and unconvincing explanations of omitted income. *See Lessman v. Comm'r*, 327 F.2d 990, 994-995 (8th Cir. 1964); *Smith v. Comm'r*, T.C. Memo. 1994-199, 1994 WL 161938 at 7-10 (U.S. Tax Ct. 1994). Over the years, the federal courts have developed a list of certain "indicia of fraud" or circumstantial evidence of fraudulent intent, including, but not exclusive to, the following: (1) intentional understatement of income, substantial in amount or in relation to reported income; (2) intentional overstatement of deductions, substantial in amount or in relation to reported income; (3) recurrence of understatement of income or overstatement of deductions for more than one tax year; (4) failure

² The federal civil tax fraud penalty is similar to Washington's evasion penalty in requiring proof, by clear and convincing evidence, of fraudulent intent to evade a known tax liability. *See, e.g., Webb v. Commissioner*, 394 F.2d 366, 377 (5th Cir. 1972). IRC § 6663 provides:

- (a) Imposition of penalty.--If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud.
- (b) Determination of portion attributable to fraud.--If the Secretary establishes that any portion of an underpayment is attributable to fraud, the entire underpayment shall be treated as attributable to fraud, except with respect to any portion of the underpayment which the taxpayer establishes (by a preponderance of the evidence) is not attributable to fraud.
- (c) Special rule for joint returns.--In the case of a joint return, this section shall not apply with respect to a spouse unless some part of the underpayment is due to the fraud of such spouse.

to file returns; (5) secret bank deposits; (6) undisclosed sources of income; (7) inadequate records; (8) false record entries; (9) implausible or inconsistent explanations for deficiencies; (10) dealing in cash; or (11) attempting to conceal illegal activity. *Webb*, 394 F.2d at 378 fn 11 (citing Howard Balter, *Tax Fraud and Evasion*, pp. 8-54 and 8-55 (3rd ed. 1963)); *Bradford v. Comm’r*, 796 F.2d 303, 307 (9th Cir. 1986); *see also* IRS Internal Revenue Manual (IRM) 25.1.2.3 (listing 65 specific “Indicators of Fraud”).³

The existence of several “indicia of fraud” is persuasive circumstantial evidence of fraud. *See, e.g., Solomon v. Comm’r*, 732 F.2d 1459, 1461 (6th Cir.1984). That said, although fraud cannot be inferred from the mere understatement of income, *consistent and substantial underreporting* is evidence of fraud, even in the absence of other indicia. *Webb*, 394 F.2d at 379 (citing *Holland v. United States*, 348 U.S. 121, 137, 75 S.Ct. 127, 99 L.Ed. 150 (1954); *Browne v. Comm’r*, 367 F.2d 386, 387 (4th Cir. 1966); *Bahoric v. Comm’r*, 363 F.2d 151, 154 (9th Cir. 1966); *Klassie v. United States*, 289 F.2d 96, 101-102 (8th Cir. 1961); *Cefalu v. Comm’r*, 276 F.2d 122, 129 (5th Cir. 1960)).

Here, we have substantial understatements of income throughout the four-year audit period. As noted above, estimated sales subject to retail sales tax for the audit period was determined to be \$. . . , and the taxpayer reported \$. . . , approximately 15 percent of this amount. Additional circumstantial evidence of intent to evade paying the tax is also present: the taxpayer overstated allowable exempt food deductions throughout the audit period, the taxpayer kept inadequate records (even after assertedly losing records to water damage and theft), the taxpayer used large amounts of cash to fund purchases with minimal documentation of such purchases, and the taxpayer provided inadequate, and unsupported, explanations for its underreporting.

It has been established by clear, cogent, and convincing evidence, that the taxpayer knew to charge and collect retail sales tax, and to report and pay its retail tax liabilities, but substantially underreported its retail sales and associated tax liability. This evidence supports a finding that the taxpayer intended to evade its known tax liability and, therefore, a prima facie case of evasion. *See* 22 WTD at 276-277 (intent to evade was established where the taxpayer failed to report retail sales on two excise tax returns when it knew from prior audits that the sales were taxable).

We note that the imposition of the evasion penalty, pursuant to RCW 82.32.090(7), does not require that there be actual sale records evidencing that the taxpayer failed to report and remit retail sales tax that it collected, as was established in 22 WTD 274, 18 WTD 163, and 18 WTD 215, and as an example of sufficient evidence of intent to evade in Rule 228(5)(f)(ii)(B). As RCW 82.32.100 makes clear, the Department can use available records to estimate both the tax and penalties that are due. Here, the facts and information available to the Department provide a basis to estimate unreported cash sales and unremitted retail sales tax. If actual sales records were required, a taxpayer could easily avoid the evasion penalty by simply failing to provide any records of retail sales showing that retail sales taxes were collected, such as occurred here. A finding of a taxpayer’s intent to evade payment of its tax liability, supported by clear, cogent, and convincing evidence, is all that is required to impose the evasion penalty pursuant to RCW 82.32.090(7). The Department has met this burden. Here, the taxpayer’s limited records show that it substantially underreported income, including retail sales tax; that it failed to maintain records to properly

³ The IRM is available on the IRS website at: www.irs.gov/irm/.

document its income; that it remitted some retail sales tax to the Department; and that it knew that tax was due to the Department.

The taxpayer's assertions in response that it correctly reported and paid its tax liabilities, and that the auditor overestimated its taxable retail sales, are subjective, self-serving statements without supporting evidence, and are insufficient to meet its burden of production to rebut the prima facie case of evasion. The taxpayer's failure to correctly report and pay its tax liabilities was the result of the taxpayer intentionally acting to avoid paying the tax, with the knowledge or belief the tax was in fact owed. The evasion penalty is upheld and the taxpayer's petition is denied.

DECISION AND DISPOSITION

The taxpayer's petition is denied.

Dated this 27th day of February 2014.