

Cite as Det. No. 16-0185, 37 WTD 057 (2018)

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

In the Matter of the Petition for Correction of ) D E T E R M I N A T I O N  
Assessment of ) No. 16-0185  
 )  
 )  
... ) Registration No. . . .  
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[1] RULE 254; RCW 82.32.100: RETAIL SALES TAX – RETAILING B&O TAX – RECORDKEEPING – REASONABLE ESTIMATES. A taxpayer’s electronic sales records were found to be inaccurate. That inaccuracy supports the Department’s use of an estimated percentage of cash sales under RCW 82.32.100(1). The taxpayer’s subsequent presentation of handwritten records, which were also found to be inaccurate and incomplete, does not negate the Department’s authority to estimate cash sales under RCW 82.32.100(1).

[2] RULE 254; RCW 82.32.100: RETAIL SALES TAX – RETAILING B&O TAX – RECORDKEEPING – REASONABLE ESTIMATES. To contest an estimated percentage of cash sales authorized under RCW 82.32.100(1), a taxpayer must establish that the estimate rests on untenable grounds or is manifestly unreasonable.

[3] RULE 254; RCW 82.32.100: RETAIL SALES TAX – RETAILING B&O TAX – RECORDKEEPING – REASONABLE ESTIMATES. It was not unreasonable to use the tip percentage the Taxpayer used for its federal income tax returns as part of an estimate of cash sales authorized under RCW 82.32.100(1).

[4] RULE 254; RCW 82.32.070; RCW 82.32.100: BUSINESS AND OCCUPATION TAX – RECORDS RETENTION – BANK DEPOSITS. Absent adequate records substantiating a non-taxable source for specific deposits, amounts deposited in business accounts were properly considered taxable business income.

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.

Kreger, A.L.J. – A Washington corporation . . . protests the assessment of retail sales tax and retailing business and occupation tax based on an estimate of cash sales. While conceding the inaccuracy of electronic records, the business asserts that handwritten records provided are

complete and accurate, and alternatively argues that the estimate used by the Audit Division is too high. [W]e affirm the conclusion that these records are not accurate and that the Audit Division reasonably exercised its authority to use an estimate. We also find that the estimate was reasonably calculated and find no evidence to establish that estimate rests on untenable grounds or constitutes an abuse of discretion. The Taxpayer also asserts that non-business income was incorrectly treated as business income. Because insufficient detail was provided to substantiate a non-business source for the remaining items, we affirm their categorization as business income. We affirm the assessment as issued and deny the Taxpayer's petition.<sup>1</sup>

## ISSUES

1. Has a Taxpayer met its obligation to maintain suitable records to establish tax liability, under RCW 82.32.070 and WAC 458-20-254, when its business records indicate an unusually low amount of cash sales?
2. Pursuant to RCW 82.32.070 and .100, did the Department of Revenue reasonably base an estimate of unreported cash sales on the Taxpayer's cash sale percentage at the start of the audit period?
3. Pursuant to RCW 82.32.070 and .100, did the Department of Revenue reasonably generate a total gross receipts amount on bank records and adjusted credit card sales data and then apply the estimated cash sales percentage to this figure?
4. Did the Audit Division properly treat amounts deposited into the Taxpayer's business accounts as taxable gross income where the Taxpayer was not able to provide source documentation substantiating the character of contested deposits?

## FINDINGS OF FACT

[Taxpayer] is a Washington corporation engaged in the business . . . in . . . , Washington. The Department of Revenue (Department) conducted an audit of the Taxpayers business activities for the period of January 1, 2010, through September 30, 2014, which determined that additional tax was due and an assessment, Document No. . . . , in the amount of \$ . . . was issued to the Taxpayer at the conclusion of the audit.<sup>2</sup> The Taxpayer timely petitioned for a review of the assessment.

The Taxpayer recorded cash and credit card sales in a point of sale (POS) system. QuickBooks accounting software was also used to record sales and operating expenses. During the audit, the POS system records were reviewed and analyzed in addition to bank statements, bank deposits, merchant credit card processing statements, and federal income tax returns. The assessment issued estimated the Taxpayer's cash sales as the records reviewed during the audit contained a number of anomalies . . . . The anomalies noted by the Audit Division included: [consistent tip percentages without variation, unusual gaps in time between sales, transactions with amounts too

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

<sup>2</sup> The assessment was comprised of \$ . . . in retail sales tax, \$ . . . in retailing business and occupation tax, interest of \$ . . . , a 5% assessment penalty of \$ . . . , and an evasion penalty of \$ . . . .

low for any item offered for sale, bank deposits made up of primarily credit card sales, consistently low cash sales percentages, and unrecorded costs related to remodeling and expanding the business.]

When the auditor discussed the anomalies found in the initial review of records with the Taxpayer on January 8, 2015, the Owner of the Taxpayer disclosed that there were two sets of records and that sales and other daily totals were adjusted to a pre-determined amount and that the excise tax returns were filed based on the adjusted records. . . . Additional POS records were provided to the auditor at this meeting; however, these records also showed atypical information, with cash sales remaining consistent throughout the audit period while total sales increased.

During this review the Taxpayer has provided handwritten sales summaries. The handwritten summaries are done by month and have four columns. The column headings are not consistent for all of the pages, and some pages have blank headings; however, the order of the columns is likely consistent despite the inconsistent labeling. The first column lists the month and date, the second heading is labeled as "cash" or in some instances "check & cash", the third column is generally headed "credit card", and the forth column is headed "sales total w/tax." Up until July of 2011, there is generally one day a week without data, while the later period include data for all days of the week, likely corresponding to a change in operating hours of the business. However, throughout the paper records there are days showing a negative amount in the cash sale column, for as many as 171 days. The initial handwritten records provided included a number of pages that were illegible. Legible copies were subsequently provided, but these records also contained the anomalous negative cash entries and lacked underlying detail.

The Taxpayer asserts that these summaries were generated throughout the audit period, but it is not possible to determine when the records were created and none of this detail was made available during the course of the audit examination. The Taxpayer asserts that this detail supports an average cash sales percentage of . . . % for 2010-2013 and . . . % for the eight months of 2014. Based on the negative cash sales and the lack of underlying source documentation, the Audit Division determined that these handwritten records were also incomplete and unreliable, and did not provide sufficient information to accurately indicate cash sales . . . .

The Audit Division estimated the business's cash sales . . . . . For the first six months of 2010, cash sales [were reported at one level]. The [business] was briefly closed for a remodel and expansion in mid-2010, and after it re-opened in July of 2010, cash was no longer being reported at the same level. The Audit Division used this [initial] cash average, derived from the Taxpayer's sales activity at the beginning of the audit period, to estimate cash sales for the subsequent period of time. To generate a total sales amount to apply this percentage, the Audit Division looked at the Taxpayer's banking records to arrive at a total credit card sales amount . . . . The credit card sales total was adjusted . . . [to account for various items not considered taxable income]. Net bank deposits from unknown sources were considered business income. [Audit also reduced the deposit total by the tip percentage Taxpayer recorded on its federal income tax return and added to the credit card sales a credit card processing fee from settlement statements provided.] . . .

The Taxpayer asserts that \$ . . . in non-business deposits were incorrectly treated as business income. At issue are 9 separate bank transfers. The Taxpayer characterizes these as contributions of capital from various individuals necessary to fund business operations. Of the contested items listed in the Taxpayer's petition, Check # . . . for \$ . . . from . . . , dated June 1, 2010, was previously allowed as a deduction, as detailed on Workpaper A. The Taxpayer has also provided copies of a . . . bank statement for July of 2010, for the Owner's account and a declaration from the Owner asserting that specific deposits were contributions to capital. The Taxpayer has identified the disputed deposits and provided a number of transfer documents, but no detail was provided to establish a non-business source for the disputed deposits.

For the tip percentage used, the Taxpayer asserts that a reconciliation between monthly cash payouts and tip amounts reported to the federal government on W-3 and W-2 forms provides a higher and more accurate average tip percentage . . . . The Taxpayer has produced copies of an annual W-3 transmittal of wage and tax statement for 2010 and W-2 earnings summaries for 2011, 2012, 2013, and 2014. Spread sheet details, generated by the Taxpayer, for a reconciliation of W-3 tips and monthly cash tip payouts, and sales summary reports were also provided. However, the federal data and monthly cash payout detail that was provided to show a higher tip percentage relies on the POS records that have been shown to be inaccurate. Additionally, these tip payout summary amounts were not provided during the underlying audit and no information or detail has been provided to substantiate a reliable source for this detail.

Regarding the credit card processing fee, during this review, the Taxpayer has provided an email from a Relationship Manager at . . . stating that their processing fees are deducted on a monthly basis on the first day of the month rather than on a transaction by transaction basis. . . .

## ANALYSIS

RCW 82.32.070 provides:<sup>[3]</sup>

- (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.

*See also* WAC 458-20-254 (Rule 254); Det. No. 99-341, 20 WTD 343 (2001).

If a person fails to keep and preserve suitable records, then RCW 82.32.100 provides:

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<sup>3</sup> [This provision was amended 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. . . . ]

(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, the electronic business records provided indicated a number of anomalies that indicated an underreporting of cash sales . . . . The cash sales percentages from the Taxpayer's federal returns are all in the single digit percentages, which is unusually low for this type of [business]. These low percentages, in addition to the other anomalies detailed above, indicated that the records provided were inaccurate and that cash sales would need to be estimated.

In this case, the Taxpayer does not dispute the inaccuracy of the electronic records available, but asserts that the handwritten detail provided is accurate, and that cash sales should be assessed at [an amount lower than that] used by the Audit Division. We disagree with the Taxpayer's assertion that these handwritten records are sufficient and should be relied upon by the Audit Division. . . .

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Furthermore, there are indications calling into question the reliability of these [handwritten] records and accordingly rendering a cash sale percentage generated from this detail unreliable. While the Taxpayer has asserted that these records are contemporaneous and were generated throughout the audit period, this detail was not offered during the course of the original audit examination, but rather [was] produced during this review. Regardless of when these records were created, the records themselves contain a significant number of days showing negative cash sales, and underlying source detail or documentation was not offered to substantiate these figures. The large number of days showing a negative cash sales amount is anomalous and itself calls into question the accuracy and completeness of this detail. Additionally, neither an explanation nor detail as to what source records support these figures, nor a representative showing of the any source documentation to substantiate these numbers for the audit period is included. We affirm that conclusion of the Audit Division that these handwritten records were not suitable or complete, and accordingly, under RCW 82.32.100, support the use of an estimate.

To further challenge the estimate used by the Audit Division, the Taxpayer notes that a 2014 survey from a credit card processor . . . indicates a trend of decreasing cash payments and an average ... cash payment percentage. While still higher than the cash percentage averages derived from the paper records, the Taxpayer asserts that this information indicates that the cash sale percentage relied upon by the Audit Division was unreasonably high, and that the cash sales percentage should decline over the course of the audit period. The Taxpayer also relies on this information as substantiating its position that the paper records are credible . . . .

In Det. No. 12-0136, 32 WTD 65 (2013) we affirmed an estimate of cash sales [ . . . ] to the industry average sales percentages as reasonable. In this case the Taxpayer took the cash sale percentage from the Taxpayer's own reporting at the start of the audit period. While it may be the case that in general cash payments as a percentage of total payments are indeed declining over time, we find no impropriety in using a consistent estimate for the entire audit period,

founded on the cash sales reported at the start of the audit period, nor is there any evidence to establish that this practice constituted an abuse of discretion.

We have previously noted and affirmed the Department's authority to assess taxes based on a reasonable estimate. *See* Det. No. 14-0106, 33 WTD 402 (2014); Det. No. 13-0302R, 33 WTD 572 (2014); Det. No. 03-0279, 23 WTD 252 (2004); Det. No. 97-134R, 18 WTD 163 (1999). All of these cases involved a single estimate being used for the entire audit period. We also note that the authority granted to the Department to make estimates of 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).<sup>4</sup>

In this case, we conclude that the Taxpayer has not established that the Audit Division abused its discretion in generating the estimate at issue. An abuse of discretion occurs when a decision rests on untenable grounds or is manifestly unreasonable. *Mayer v. Sto Indus., Inc.*, 156 Wn.2d 677, 684, 132 P.3d 115 (2006). . . . The estimate used here was based on the Taxpayer's cash sales average at the start of the audit period, and we conclude that this constituted a reasonable basis for the estimate.

The Taxpayer also takes issue with several specific steps undertaken by the Audit Division in computing the total business income at issue to which the ... estimate was applied, [s]pecifically, the use of the ... tip average from the Taxpayer's federal tax returns and the manner in which credit card processing fees were addressed.

The Taxpayer asserts that there is a more accurate tip percentage based on other federal data and monthly cash payout detail. The Taxpayer has produced copies of an annual W-3 transmittal of

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<sup>4</sup> The 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 5-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 1-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).

wage and tax statement for 2010, and W-2 earnings summaries for 2011, 2012, 2013, and 2014. Spread sheet detail, generated by the Taxpayer, for a reconciliation of W-3 tips and monthly cash tip payouts, and sales summary reports were also produced. Again, this detail was not provided during the underlying audit. Additionally, it appears that this information is based on, and incorporates, the unreliable POS information, which also calls its reliability into question. Comparable to the selection of the cash sale percentage, we conclude that Audit Division did not abuse its discretion in using the ... tip percentage from the Taxpayer's federal tax returns rather than the alternate computation offered by the Taxpayer during this review, and that this detail provided a reasonable basis for generating total business income as part of estimating underreported cash sales.

Next the Taxpayer asserts that the Audit Division incorrectly added back in the credit card processing fee to the credit card charges, effectively doubling the fee. The Taxpayer has provided an email from [its] credit card processor detailing that the fees are deducted monthly rather than being deducted from each individual credit card transaction, which is how other processors compute this fee. The Taxpayer does not dispute that the processing fee at issue was [a percentage]. What the Taxpayer has failed to establish is that the monthly deductions at issue were not part of the credit card computation used by the Audit Division. Whether deducted as larger monthly charge or deducted on a per charge basis, these fees were subtracted from the gross receipt that is subject to tax, and accordingly, were correctly added back to arrive at a total gross receipt amount subject to tax. For the addition of this fee amount to be improper, the Taxpayer would need to detail that the monthly deductions were already omitted from the credit card gross receipt figure in the audit computation, and the Taxpayer has not done so. Accordingly, we conclude that the Audit Division reasonably added this percentage back into its gross receipts computation.

Finally, on the issue of the alleged non-business deposits, the Taxpayer provided a legible copy of Check # . . . for \$ . . . from . . . dated June 1, 2010. The Audit Division has reviewed this check and confirmed that this amount was already allowed as a deduction, as detailed on Workpaper A. Thus, no further adjustment on this deposit is required. Copies of the Owner's account at a . . . bank and declaration from the Owner were also provided. However, this is insufficient to detail that amounts from this account were not business income.

We do not dispute that it is credible that a business owner would contribute personal funds to a business. Taxpayer seeks to exclude a number of deposits from its taxable income. The Department requires specific documentation to exclude alleged non-business deposits from gross income for B&O tax purposes. Det. No. 14-0106, 33 WTD 402 (2014). Where documentation establishing a non-business source was available for specific deposits the amounts were excluded. However, the fact that funds were transferred from the Owner's foreign bank account does not independently support that amounts in that account had a non-business source. It is equally possible that business income was transferred into that account. Absent specific information on the source of the contested deposits, we concluded that the Audit Division properly considered the deposits at issue as business income subject to tax.

We sustain the assessment as issued as the Taxpayer has failed to establish that the estimate used was manifestly unreasonable or that amounts were incorrectly included in taxable gross income.

**DECISION AND DISPOSITION**

Taxpayer's petition is denied.

Dated this 19th day of May 2016.