

Cite as Det. No. 17-0173, 38 WTD 38 (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. 17-0173
	)	
...	)	Registration No. . . .

WAC 458-20-254; RCW 82.32.070; RCW 82.32.100: SUITABLE RECORDS – AUTHORITY TO ESTIMATE - Audit met the statutory standard in RCW 82.32.100 by proceeding in the manner that it deemed best to obtain facts and information on which to base its estimate of tax, by observing the manner in which customers actually paid throughout five visits to Taxpayer’s restaurant and calculating a cash payments percentage to estimate gross income.

WAC 458-20-228; RCW 82.32.105: EVASION PENALTY – CLEAR, COGENT, AND CONVINCING EVIDENCE A OF INTENT TO EVADE – Taxpayer’s hiring a bookkeeper and history of charging customers retail sales tax at the correct rate is clear, cogent, and convincing evidence that it had knowledge of its B&O tax and retail sales tax, liabilities. Taxpayer’s entering cash sales into its POS system, providing customers with receipts for the cash sales, and then providing the Department with business records that do not show the cash sales entered into the POS system, is clear, cogent, and convincing evidence that Taxpayer engaged in intentional acts to escape detection and payment of such tax liabilities.

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.

Anderson, T.R.O. – A buffet restaurant disputes assessments of tax and penalties resulting from an estimate of cash sales. The restaurant asserts that the Department erred in estimating the percentage of cash sales by observing customer payments and calculating an average percentage of the frequency at which customers paid in cash, instead of selecting an industry average percentage. The restaurant also asserts the Department has not shown that it intended to evade paying taxes. Petition denied.<sup>1</sup>

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

## ISSUES

1. Did the Department calculate a reasonable estimate of cash sales, under RCW 82.32.100, when it observed customer payment type on several occasions and averaged these observations to estimate the frequency at which customers paid in cash?
2. Did the Department show, under RCW 82.32.105, that a restaurant intended to evade paying retailing business and occupation tax and retail sales tax, where the restaurant did not report or pay taxes on undercover cash purchases made by the Department and on other evidence?

## FINDINGS OF FACT

... (“Taxpayer”) operates ... a buffet restaurant featuring ... food in ... Washington.

The Department’s Audit Division (“Audit”) reviewed Taxpayer’s books and records from February 1, 2013, through March 31, 2016 (the “Audit Period”). Eventually, for reasons explained below, Audit concluded that Taxpayer’s books and records were unreliable and estimated Taxpayer’s retail sales during the Audit Period.

On October 28, 2016, Audit issued a \$ ... assessment against Taxpayer [that included] \$ ... in retail sales tax; \$ ... in retailing business and occupation (“B&O”) tax; \$ ... in use tax/deferred retail sales tax; a \$ ... credit for paid B&O syrup tax; \$ ... in interest; \$ ... in evasion penalty; and \$ ... in assessment penalty. Taxpayer requests review of this assessment and raises two objections; first, Taxpayer disputes the method used to calculate an estimate of cash retail sales (and assess retailing B&O tax and retail sales tax), and, second, Taxpayer disputes the assessment of the evasion penalty.

### **Unreliability of Taxpayer’s Records**

Audit visited Taxpayer’s restaurant on several occasions to observe restaurant operations. These visits occurred before and during its review of Taxpayer’s books and records; some of these visits were announced and some were not.

During five of the unannounced visits, Audit purchased food and beverages from Taxpayer; paid for the items with cash; and received a receipt from Taxpayer’s electronic point-of-sale system.<sup>2</sup> . . . None of the five purchases were listed in the books and records that Taxpayer provided to Audit for review.

Audit also observed [a second point-of-sale terminal located in the back of Taxpayer’s restaurant, unusual cash handling procedures, abnormal business operations costs, and a volatile pattern of

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<sup>2</sup> Audit made five purchases of meals and beverages and paid in cash, on the following dates and amounts: (1) December 18, 2015 - \$ . . . ; (2) January 19, 2016 - \$ . . . ; (3) January 20, 2016 - \$ . . . ; (4) January 26, 2016 - \$ . . . ; and (5) January 31, 2016 - \$ . . . .

total retail sales and credit/debit card payments.<sup>3</sup> Finally, although it was apparent that Taxpayer made cash sales, none of its cash sales were recorded in the accounting records it provided to Audit.]

...

Audit concluded that Taxpayer's books and records were unreliable based on these observations. Taxpayer does not dispute this conclusion.

### **Estimate of Retail Sales**

Because Audit concluded that Taxpayer's books and records were unreliable, Audit calculated an estimate of Taxpayer's retail sales during the Audit Period. Audit's estimate of total retail sales is comprised of estimated credit/debit card payments and estimate[d] cash payments.

...

To estimate cash payments, Audit relied upon several observations of the frequency at which Taxpayer's customers paid in cash.

During five visits to Taxpayer's restaurant, Audit observed and tracked the number of cash and credit/debit card payments, as follows:

<b>Date</b>	<b>Visit Duration</b>	<b>Observed Cash Payments</b>	<b>Observed Credit/Debit Payments</b>	<b>Observed % Cash Payments</b>
Jan. 31, 2016	2:32pm – 3:27pm	5	15	25%
July 26, 2016	12:30pm – 1:15pm	9	2	82%
Aug. 3, 2016	5:00pm – 6:00pm	3	4	43%
Aug. 10, 2016	1:00pm – 2:00pm	4	2	67%
Aug. 11, 2016	12:20 – 1:20pm	8	7	53%

Audit used these observations to calculate an average percentage of the frequency at which Taxpayer's customers paid in cash (relative to total payments). . . .

By using the credit/debit card payment data and observed (average) cash payment percentage, Audit was able to impute an estimate of cash retail sales. . . . Audit added the estimate of total cash retail sales to the verified total of credit/debit card retail sales and assessed retail sales tax and retailing B&O tax to the extent that this sum exceeded amounts reported by Taxpayer.

### **Taxpayer's Assertions**

Taxpayer requests review of the assessment. Taxpayer does not dispute Audit's conclusion that its books and records are unreliable and an estimate is necessary. . . .

<sup>3</sup> [Taxpayer utilized an electronic point-of-sale system to record sales with two terminals: one located in the front of the restaurant with a cash drawer, computer, monitor, receipt printer, and payment card reader; and the other located in the back of the restaurant with a computer, monitor, and receipt printer.]

Taxpayer disputes Audit's estimated cash payment percentage of 47% and asserts its use produces an unreasonable estimate of assessed tax. Taxpayer raises the following concerns about the use of the observed cash payment percentage:

- (1) The observed cash payment percentage is much higher than industry averages and those used in prior Department Determinations – specifically, Dets. Nos. 05-0350, 35 WTD 291 (2014); 12-0136, 32 WTD 65 (2014); 13-0272, 33 WTD 70 (2014); and 13-0302R, 33 WTD 572 (2014);
- (2) The percentage was calculated without reference to the purchase amount;
- (3) The percentage ignores the well-known trend away from cash; and
- (4) The percentage was calculated based on a relatively small number of observations, under 10 hours of observations in total.

Taxpayer asserts that instead of using the observed cash payment percentage of 47%, the Department should use [the] restaurant-industry average cash payment percentage of 27%.

Taxpayer also disputes the assessment of the evasion penalty on the basis that Audit has failed to show by clear, cogent, and convincing evidence that Taxpayer intended to evade the payment of tax during the Audit Period.

## ANALYSIS

### Estimate

RCW 82.32.070 provides:

- (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.

RCW 82.32.070(1). The Department explains in WAC 458-20-254 (the Department's Administrative Rule applying the statutory recordkeeping requirement) that these records must demonstrate the amounts of: (i) gross receipts and sales from all sources; (ii) deductions, exemptions, or credits claimed; (iii) payments of retail sales tax or use tax; and (iv) refunds claimed. WAC 458-20-254(3)(b).

Taxpayer [kept incomplete] records of sales –[none of the] five Department purchases appeared in Taxpayer's business records. The records that Taxpayer did keep show financial information inconsistent with restaurant industry financial benchmarks and ratios. Audit struggled to understand how Taxpayer could continue to operate with such a high cost of goods sold and rent expense (both expressed as a percentage of reported sales). In addition, Taxpayer employed an unusual practice of recording those business expenses paid for with cash, once a year, instead of contemporaneous to the purchases. These circumstances [supports the conclusion] that Taxpayer's records were not suitable in accordance with RCW 82.32.070[, which Taxpayer does not dispute].

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

- (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 tax; and to this end the department may examine the records of any such person as provided in RCW 82.32.110.

RCW 82.32.100(1). This statutory provision affords the Department wide discretion in the methodology employed to calculate a reasonable estimate of tax. *See* Det. No. 15-0350, 35 WTD 291 (2015) (“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 (2004); Det. No. 97-134R, 18 WTD 163 (1999)”).

The Department employs a broad range of methodologies in estimating tax liability. Published determinations show the Department using the following to estimate gross income: industry studies, bank statements, Federal income tax records, records of employee wages, purchase records, and statistical and block sampling. [*See*] Det. No. 15-035, 35 WTD 291 (2015) (estimate of cash sales based on industry study on payment methods); Det. No. 16-0218, 36 WTD 063 (2016) (estimate of income based on bank statements); Det. No. 15-0148, 35 WTD 10 (2015) (estimate of unreported income and sales and use tax based on Federal income tax apportionment schedules and trial balance reports); Det. No. 15-0026, 34 WTD 373 (2015) (estimate of income and uncollected retail sales tax based on records of wages of workers); Det. No. 11-0346, 32 WTD 60 (2011) (estimate of retail sales tax based on purchase records); Det. No. 10-0386, 32 WTD 81, 91 - 92 (2010) (discussing Department’s use of statistical sampling and block sampling).

[For] restaurants, published determinations show the Department [has employed at least] two methodologies to estimate cash sales: (1) Substituting a percentage of cash sales based on industry studies on customer payment practices; and (2) calculating a percentage of cash sales based on point-of-sale system voids where numbered meals tickets were missing and the auditor observed two out of five customers paid in cash. [Det. No. 15-035,] 35 WTD 291; Det. No. 13-0272, 33 WTD 70 (2013); Det. No. 12-0201, 32 WTD 151 (2012); Det. No. 12-0136, 32 WTD 65 (2012); Det. No. 13-0302R, 33 WTD 572 (2014).

Here, Audit employed an estimation of cash sales method based on averaging several observations of customer payment methods. Taxpayer asserts that we should substitute an industry average of 27% cash sales because Audit’s method produces an unreasonable estimate[. Taxpayer contends the estimate is unreasonable] for the following reasons: (1) [it was based] on observations made during a relatively brief period of time; (2) [the] result falls outside comparable industry benchmark or average; (3) [the] result is higher than estimates used in all published determinations; (4) [the] method has not been sustained in [a] published determination; (5) [the method] assumes all cash sales are for the same average amount as all non-cash sales; and (6) [it] ignores [the] trend away from cash. Ultimately, as explained below, Taxpayer’s assertions do not persuade us [that Audit’s estimate was manifestly unreasonable].

As noted above, RCW 82.32.100 affords the Department broad discretion in estimating tax. The Department is [permitted] to employ whichever methodology it deems best [absent a showing that it has abused its discretion. It] is not bound to only those methodologies sustained in published determination. . . .

...

[Here,] Audit determined that it would need to estimate [Taxpayer's] retail sales based on the limited reliable business information available. Audit had reliable records of the amounts of credit/debit card retail sales. . . [,] but no records of cash retail sales. . . .

. . . Audit [chose to estimate cash sales by first computing a percentage of cash sales to total sales. To arrive at this percentage, Audit observed the manner in which] customers actually paid. Throughout five visits to Taxpayer's restaurant, during the lunch hour, mid-day, and dinner hour, spread over several months, Audit observed and tracked how customers paid for meals. These visits resulted in a randomized and comprehensive sample of customer payment type. . . . Audit [disregarded its observations from] one visit that seemed to have an unusually high percentage of cash payments and averaged the remaining percentages to [arrive at] a cash payments percentage of 47%.

Taxpayer assigns error to Audit's sampling because the observations were made during a brief period of time, the percentage does not take into account the sales amounts and the likelihood that cash payment decreases with an increase in amount, and [Audit] ignores the payment trend away from cash.

There is truth to Taxpayer's assertion about Audit's method not taking into account sales amounts, but the same issue would also be present if Audit substituted Taxpayer's percentage. Taxpayer's conjecture does not make Audit's estimate of Taxpayer's cash sales percentage unreasonable.

Further, as to Audit's method not recognizing a payment trend away from cash over time, we find the opposite to be true. Audit made observations . . . at the end of and after the close of the Audit Period and projected back in time over the Audit Period. [This means] Taxpayer [received] the benefit of the decreased 2016 cash payment percentage for years in which the cash payment percentage was higher than 2016 – 2013, 2014, and 2015 – according to the trend cited by Taxpayer.

We sustain the estimated assessment. Audit met the statutory standard in RCW 82.32.100 by proceeding in the manner that it deemed best to obtain facts and information on which to base its estimate of tax and Taxpayer has failed to persuade us that the method employed by Audit produced an unreasonable estimate.

## Evasion Penalty

RCW 82.32.090 requires the Department to assess an evasion penalty in certain circumstances and reads, “If 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.” RCW 82.32.090(7).

WAC 458-20-228 is the Department’s administrative rule that explains and illustrates the application of the evasion penalty. It reads in pertinent part as follows:

The evasion penalty is imposed when a taxpayer knows a tax liability is due but attempts to escape detection or payment of the tax liability through deceit, fraud, or other intentional wrongdoing. An intent to evade does not exist where a deficiency is the result of an honest mistake, miscommunication, or the lack of knowledge regarding proper accounting methods. The department has the burden of showing the existence of an intent to evade a tax liability through clear, cogent and convincing evidence.

WAC 458-20-228(5)(f). Thus, there are two elements to establishing an “intent to evade”: (1) knowledge of a tax liability; and (2) an intentional act to escape detection or payment. *Id.*; see also Det. No. 13-0329, 33 WTD 156 (2013). Clear, cogent, and convincing evidence has been described as evidence convincing the trier of fact that the issue is “highly probable,” or, stated another way, the evidence must be “positive and unequivocal.” *Colonial Imports, Inc. v. Carlton Northwest, Inc.*, 121 Wn.2d 726, 735, 853 P.2d 91 (1993).

Here, Taxpayer hired a bookkeeper to report and pay taxes to the Department. Taxpayer had a history of reporting business income under the correct . . . B&O tax classification. Taxpayer also had a history of charging its customers retail sales tax at the correct rate. We conclude that this tax . . . history is clear, cogent, and convincing evidence that Taxpayer had knowledge of its B&O tax liability and retail sales tax liability.

Regarding intent, the Washington State Supreme Court has stated:

The intent with which an act is done is a mental process, and as such generally remains hidden within the mind where it is conceived, and is rarely, if ever, susceptible of proof by direct evidence. However, intent may be inferred or gathered from the outward manifestations, by the words or acts of the person entertaining it, and the facts and circumstances surrounding [the alleged offense].

*State v. Gaul*, 88 Wash. 295, 301, 152 P. 1029, 1032 (1915). Here, Taxpayer’s outward manifestations were: (1) collecting retail sales tax from customers at the correct rate; (2) entering cash [sales] into [its] POS system and providing customers [with] receipts [showing the cash sales]; and (3) providing the Department with business records that do not show cash [sales] that Taxpayer entered into its POS system. Taxpayer offers no explanation as to why the cash [sales] entered into the POS system did not appear in business records.

Taxpayer's bookkeeper stated that she would report and pay taxes to the Department based on the amounts listed in Taxpayer's business records. The effects of Taxpayer's outward manifestations were to reduce Taxpayer's B&O tax liability and retail sales tax liability because the business records reflected a lower amount of reported sales. The effect of Taxpayer's outward manifestations also produced a windfall for Taxpayer in the amounts of retail sales tax collected but not remitted because the business records did not report such sales.

We conclude that Taxpayer's outward manifestations are clear, cogent, and convincing evidence that Taxpayer undertook an intentional act of removing [cash sales] from [its] business records to escape detection and payment of taxes with respect to the removed transactions. Accordingly, we conclude that the Department has shown Taxpayer intended to evade payment of retailing B&O taxes and retail sales tax. *See also* WAC 458-20-228(5)(f)(ii)(B) (The willful failure of a seller to remit retail sales taxes collected from customers to the Department is generally considered an action that establishes an intent to evade a tax liability).

Once the Department has clearly established the elements of evasion, a burden of production is imposed on the taxpayer to produce evidence of honest mistake, miscommunication, ignorance of law, lack of knowledge, or some other fact that tends to rebut the Department's evidence. Det. No. 16-0066, 35 WTD 540 (2016). Taxpayer has offered no such evidence or even an explanation for the reason transactions were missing from its business records. Accordingly, we sustain the assessments of evasion penalties.

#### DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 14th day of July 2017.