Cite as Det. No. 13-0302R, 33 WTD 572 (2014)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of Letter Ruling issued to	)	D E T E R M I N A T I O N
	)	
	)	No. 13-0302R
. . .	)	
	)	Registration No. . . .
	)	

[1] RULE 254; RCW 82.32.070 RETAILING B&O TAX – RECORDKEEPING. Where the business records provided show an extremely low volume of cash sales, which are significantly below industry norms for the Taxpayer's type of business, this is sufficient evidence for the Audit Division to conclude that the available business records are not suitable to establish the tax due for the period under audit.

[2] RULE 254; RCW 82.32.100; RETAIL SALES TAX – RETAILING B&O TAX – RECORDKEEPING – REASONABLE ESTIMATES. An industry study on customer payment practices is a reasonable and acceptable source of facts and information to establish an estimated percentage of cash sales under RCW 82.32.100(1), where the Taxpayers records are not suitable.

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 company operating a restaurant protests an adjusted assessment of tax for unreported cash sales, asserting that all sales were reported. We affirm the adjusted assessment because business records were insufficient and the Audit Division reasonably exercised its authority to arrive at an estimate of cash sales. We deny the Taxpayer's petition.[1]

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?

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

2. Pursuant to RCW 82.32.070 and RCW 82.32.100, did the Department of Revenue base an estimate of unreported cash sales on voided sales in the available business records?

FINDINGS OF FACT

[Taxpayer] is a Washington corporation engaged in the business of operating a restaurant in . . . Washington. The Department of Revenue (Department) conducted an audit of the Taxpayer's business activities for the period of January 1, 2008, through December 31, 2011. The audit resulted in an assessment being issued for additional tax due in the amount of $. . . .[2] The bulk of the assessment is attributable to retail sales tax and retailing business and occupation (B&O) tax being assessed on a portion of voided sales transactions which were used to generate an estimate of unreported cash sales in light of the exceptionally low level of cash sales being reported by the Taxpayer. The Taxpayer timely appealed the assessment.

The audit used a sampling methodology to verify the reporting of cash sales. The initial review of the detail from the point of sale (POS) system records indicated an abnormally low level of cash sales, at around 1% of total sales. Expecting a cash sales percentage of around 33%, the auditor determined that cash sales had been omitted from the business records and the reported sales. Rather than just relying on an expected average percentage of cash sales and imputing sales to get to that percentage, the [Audit Division] based [its] calculation on data from the available business records. The auditor used a random sample to select 30 days during the audit period. Once the 30 specific days were selected, the auditor then reviewed the complete sales detail for dinner checks for each of those days. The auditor reviewed the beginning and ending ticket numbers for each selected day in the sample and then compared the total range of ticket numbers with the ticket numbers actually recorded in the point of sale (POS) system records. Missing ticket numbers were identified as errors and the error rate from the sample was then used to project an error rate over the entire audit period. The total cash sales which resulted from this method resulted in unreported cash sales comprising 31% of total sales, which is within the range of expected cash sales for this type of business.

The very low volume of cash sales reported by the Taxpayer was also noted as being at odds with the direct observation of the Taxpayer's business activities. In observing lunch sales the auditor observed a number of cash sales, which he estimated as 2 of every 5 sales watched and also noted that several cash sales did not appear to be entered into the POS system.

On appeal, the Taxpayer disputed the treatment of voided sales identified during the audit as cash sales and produced additional records to establish that the assessment overstated the cash sales. The Audit Division agreed that additional review was warranted and the matter was remanded for possible adjustment. Based on the additional information provided, the

[2] The Assessment Document No. 2013065242, was comprised of $. . . in retail sales tax, $. . . in retailing business and occupation (B&O) tax, a credit for ($. . .) in service and other activities B&O tax, $. . . in use tax, interest of $. . . and an assessment penalty of $. . .

assessment was adjusted downward, resulting in the revised tax liability of $. . . .[3] The adjustment is attributable to a reduction in the retail sales tax and retailing business and occupation tax based on a portion of the voided ticket sales being substantiated as actual voids or cancelled tickets. The revised assessment reduces the unreported cash sales percentage to 21%.

Believing that adjusted assessment still overstated cash sales, the Taxpayer sought reconsideration of the adjustments made by the Audit Division on remand. The Taxpayer asserts that the business records provided are complete, that there are alternate explanations for the voids in the POS system, and the level of cash sales reported is correct as fewer and fewer customers are using cash.

On reconsideration the Taxpayer has provided detailed information about the POS system, explaining . . . a number of instances which will result in a sale being voided. . . . [This] includes[] when two tickets are combined or joined, which can occur when different tickets are used for a drink order, an appetizer order, and an entrée order and these three tickets are then merged together. In that instance, what was initially three different ticket numbers will actually only result in one merged ticket number, which is the ticket that is run for the sale at the end of the meal. Conversely, a void will also be created when a single ticket is split to provide separate checks for different diners at a single table and there is an error in allocating the items to the separate tickets. In that case to move an item from one ticket to the other an interim ticket will be created, which will then be voided out after the item is moved to the corrected ticket. Voids are also used when an item is removed from a ticket for a variety of reasons including: a customer complaint, [instances when] the item was not actually ordered by the customer, or because the server or management decides not to charge for a particular item. In these instances an interim ticket is also created for the item that is being removed from the bill. In that instance again the interim ticket will be voided out. While the Taxpayer has identified a variety of different reasons for the voids, the business records can not characterize the specific missing sales tickets in the sample period as being attributable to a specific reason.

The Taxpayer provided a declaration from the salesman who sold the POS to the Taxpayer detailing how the system creates voids and that the system does not store a record of merged ticket numbers. The Taxpayer also provided taped examples of how sales are rung into the POS system, which detailed examples of how different types of transactions result in voided sales. The Taxpayer also provided a declaration from the owner of the business detailing the use of the POS system.

ANALYSIS

RCW 82.32.070 provides:

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[3] The adjusted assessment was comprised of $. . . in retail sales tax, $. . . in retailing B&O tax, a credit for ($. . .) in service and other activities tax, $. . . in use tax, interest of $. . . , and an assessment penalty of $. . . .

> 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.

RCW 82.32.070; *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:

> (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.

RCW 82.32.100(1). In this case, the business records indicated an underreporting of cash sales. The POS records showed a cash sales percentage for the dinner period being reviewed in the test period generated from the sampled records of 1.18%, which is significantly below industry norms for this type of business. The Audit Division indicated in their response to the initial appeal petition that they expect a restaurant like the Taxpayer's to have cash sales around 33% of total sales.

This expected level of cash sales is based on general experience gained through auditing comparable businesses and also supported by two specific industry studies addressing consumer payment patterns. Specifically the Audit Division relies on a 2008 industry study, prepared by First Data and a 2010 study prepared by Hitachi Consulting, which detail average cash purchase percentages for different categories of merchants making retail sales.[4] The 2008 industry study details that electronic payments are growing across all surveyed retail locations, but also notes that payment methods vary between retailers. Restaurants' cash sales on average range between 30 to 66 percent of . . . total sales, with fast food type restaurants at the high end of that range. Thus, fast food restaurants with their comparatively lower per sale average costs average 66% cash sales; and consumers' tendency to use electronic payments methods increases in correlation with the average total meal cost, as one moves along the spectrum to full service restaurants. The 2010 study results are similar, indicating average cash payments averages of 55% at fast food restaurants, 33% at coffee shops, and 27% cash payments at restaurants.

[4] First Data Corporation – 2008 Market Brief study on Consumer Payment Preferences for In-Store Purchases. First Data is a credit card processing company and conducted this nationwide study in 2008. 2010 BAI & Hitachi Study of Consumer Payment Preferences, dated January 25, 2011.

The Taxpayer's restaurant is not a fast food establishment, but a casual dining restaurant offering both a fixed price buffet and regular menu items at lunch and a full dinner menu. Thus, the expected cash sales percentage may arguably fall to the lower end of the spectrum. The adjusted assessment results in cash sales of 21% which is still below the 2010 study general restaurant average of 27%. Additionally, we note that the 1% cash sales percentage that the Taxpayer asserts is accurate is significantly lower than the cash sales average for any merchant category. In the 2010 study, the merchant with the lowest cash sales was Department Stores and those stores still had 14% cash sales.[5] Similarly, the 2008 study also identifies Department Stores as the type of merchant with the lowest level of cash sales; and even that type of retailer still had a 15% average for cash sales.[6] We agree with the Taxpayer that fewer customers are electing to pay in cash; however, the cash sales percentage that is reflected in the available business records is not only not reasonable for a comparable restaurant but is materially lower than the expected range of cash sales any type of retail merchant.

Therefore, we conclude the Audit Division correctly concluded that the available business records were not suitable and did not accurately reflect business income from cash sales. Specifically, [we conclude] that the 1% cash sales percentage indicated by the Taxpayer's business records was not credible and that the business records and returns as filed indicated an underreporting of cash transactions. Based on this conclusion, under RCW 82.32.100(1), the Audit Division was authorized to estimate the missing cash sales income in the manner they deemed best. Rather than just relying on an average sales percentage for restaurants as the basis to estimate cash sales, in the case the Audit Division used the available records to project an error rate based on the voids in the POS system records. We conclude that the estimate of cash sales in this case was reasonably based on facts and information and falls within the broad discretion granted to the Audit Division under RCW 82.32.100(1) in developing estimates. *See also* Det. No. 12-0136, 32 WTD 65 (2013) (affirming estimate of cash sales for a restaurant based on the industry average sales percentages as reasonable).

The Taxpayer generally asserts that the estimate of cash sales is too high and has provided a general explanation of possible sources of the voided sales at issue. However, in light of the inadequate record of cash sales, the Taxpayer has failed to establish 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).

We note that a taxpayer bears the burden of proof when contesting a tax assessment. RCW 82.32.160, -.180; *Budget Rent-A-Car of Washington-Oregon, Inc. v. Dep't of Revenue*, 81 Wn.2d 171, 500 P.2d 764 (1972). The taxpayer must prove that a tax assessment should be

[5] In addition to the types of merchants detailed above, the 2010 study shows grocery stores with 19% cash sales, drug stores with 25% cash sales, discount/warehouse stores with 20% cash sales, gas stations with 22% cash sales, cinema with 36% cash sales, and transit with 15% cash sales.

[6] The types of retail locations addressed in the 2008 survey and their cash sales percentages included: Department Store - 15%, Discount Store – 20% , Grocery Store -- 21%, Gas/Convenience Store – 24%, Drug Store -- 26%, Restaurant – 30%, Cinema/Theatre -- 59%, Transit – 64%, and Fast Food -- 66%.

modified or cancelled. *Group Health Co-op v. Tax Comm'n*, 72 Wn.2d 422, 433 P.2d 201 (1967). This burden of proof is consistent with and parallel to the presumption of correctness afforded a tax assessment issued by the Internal Revenue Service (IRS). *See, e.g., United States v. Janis*, 428 U.S. 433, 440, 96 S.Ct. 3021, 49 L.Ed.2d 1046 (1976); *Palmer v. IRS*, 116 F.3d 1309, 1312 (9th Cir. 1997).

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 Stated 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 (2002).[7]

We find no evidence that the Audit Division's estimate abused its discretion in determining the need to estimate cash sales or that it acted unreasonably in generating that estimate. We affirm the adjusted assessment and deny the Taxpayer's petition for reconsideration.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 25th day of August 2014.

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[7] 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 (10th Cir. 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 (9th Cir. 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 (3rd Cir. 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 (7th Cir. 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)