Cite as Det. No. 20-0175, 41 WTD 173 (2022)

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

In the Matter of the Petition for Correction of Assessment of	)	D E T E R M I N A T I O N
	)	
	)	No. 20-0175
	)	
. . .	)	Registration No. . . .
	)	

[1] WAC 458-20-254; RCW 82.32.070; RCW 82.32.100: RETAIL SALES TAX – RETAILING B&O TAX – RECORDKEEPING. When the taxpayer's business records are incomplete, show more tips than what it reported on federal returns, show a high volume of voided sales and missing checks, and are missing sales observed by Department personnel, the taxpayer has not met its obligation to maintain suitable records.

[2] WAC 458-20-254; RCW 82.32.070; RCW 82.32.100: RETAIL SALES TAX – RETAILING B&O TAX – REASONABLE ESTIMATE. The taxpayer failed to establish that the estimated assessment capped using a 31 percent cost of goods sold ratio was unreasonable by asserting that studies show different ratios, and the estimated assessment does not reflect sales data.

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.

Margolis, T.R.O. – The operator of a . . . restaurant (Taxpayer) protests an estimated assessment of retailing business and occupation (B&O) tax and retail sales tax on grounds that it provided adequate records to demonstrate the measure of its sales and that the estimated assessment is unreasonable and should be adjusted. We deny the petition.[1]

ISSUES

1. Whether Taxpayer has 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 for the audit period are incomplete, show more tips than what it reported on federal returns, show a high volume of voided sales and missing checks, and are missing sales observed by Department personnel.

2. Whether, under RCW 82.32.070 and RCW 82.32.100, the Department was authorized to estimate Taxpayer's cash sales, and the estimate was reasonable.

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

FINDINGS OF FACT

Taxpayer operates a . . . restaurant in . . . , Washington. The Department of Revenue's Audit Division (Audit) examined Taxpayer's records for the period January 1, 2014, through June 30, 2018, and on May 24, 2019, issued a Notice of Balance Due against Taxpayer for $. . . . This amount is composed of $. . . in retailing B&O tax, $. . . in retail sales tax, $. . . in use tax, $. . . in deferred sales tax, $. . . in litter tax, $. . . in 50% reseller permit misuse penalty, $. . . in 5% assessment penalty, and $. . . in interest.

For periods prior to September 7, 2016, Taxpayer maintained and provided only monthly summary reports from its old point of sale (POS) system. These reports list payments by check, gift card, credit card, and cash, and tips paid out, but fail to show any sales detail or make any reference to revenue or sales tax. For subsequent periods, Taxpayer used . . . POS, and provided Audit with an Excel download of sales detail.

Tips recorded on Taxpayer's federal payroll tax returns are far less than tips recorded in its POS systems. Specifically, for the audit period, Taxpayer reported $. . . in taxable social security tips, but its POS systems recorded $. . . [an amount approximately six times greater than the reported taxable social security tips] in tips (despite Taxpayer explaining that its POS systems only recorded tips paid by credit card).

Taxpayer's records show a rapidly declining cash sales to total sales ratio. For January 2014, its records show 20-percent cash sales, but by August 2017, this decreased to only 8-percent cash sales. The cost of goods sold to revenue ratio is as follows: 47 percent in 2014, 42 percent in 2015, 39 percent in 2016, and 39 percent in 2017. Audit notes that this ratio is unusually high.

September 13, 2016, and June 27, 2018, are the only days where Taxpayer's records show minimal gaps in check sequence numbers (on average, there were 34 gaps). The percentage of cash in total sales amounts on these days, for most large sales as well as for total sales, is substantially higher than that for the audit period with POS detail, which evidenced substantial gaps in check sequence numbers:

September 13, 2016		
$ sale	# cash sales	% cash of total $ sales
1-9	15	35
10-19	21	34
20-29	14	43
30-39	2	19
40-49	1	48
50-59	1	32
60+	-	0
TOTAL SALES		30

June 27, 2018		
$ sale	# cash sales	% cash of total $ sales
1-9	10	42
10-19	11	24
20-29	8	19
30-39	5	41
40-49	2	52
50-59	-	0
60+	1	45
TOTAL SALES		29

Audit Period with POS detail		
$ sale	# cash sales	% cash of total $ sales
1-9	5,883	40
10-19	4,797	18
20-29	1,442	8
30-39	251	4
49-49	40	1
50-59	13	1
60+	9	0
TOTAL SALES		10

Seven (7) of the 100 largest cash transactions recorded in Taxpayer's records occurred on September 13, 2016, and June 27, 2018, despite sales detail covering the 564 days that Taxpayer was open between September 7, 2016 and June 30, 2018. This is unlikely to have occurred based on random chance, indicating that these days reflect a more complete accounting of cash sales.

Taxpayer's records show a very low volume of cash sales versus credit card sales. For sales over $40, the records show only 62 cash payments, versus 5,398 credit card payments for the entire Audit Period. Thus, over a 22-month period, when the business was open for 564 days, Taxpayer's records indicate that, on average, only about 3 customers per month made cash payments on sales over $40.

Taxpayer's records show a high volume of missing check numbers. The POS system is set up to start each day with check number 100, and progress through subsequent numbers throughout the day. However, from September 7, 2016 through June 30, 2018, the POS system is missing 19,218 checks. For example, on May 2, 2018, the following checks are missing from the expected sequence: 102, 107, 112, 119, 127, 128, 134-137, 148, 155, 159-160, 162, 167, 170, 174, 176, 184, 187, 189, 191, 195, 201, 215, 233, 241, 244, 256, 261, 263, and 265.

Taxpayer's records show a large volume of voided cash sales as compared to completed cash sales. Voided sales were pervasive, and for the period September 7, 2016 through June 30, 2018, the POS system recorded 16,791 voided cash sales, but only 12,435 completed cash sales for $1 or more (sales under $1 only total $60). The records also show long gaps between completed cash sales. For example, on February 5, 2018, the records show a cash sale at 5:02PM, followed by 10 voided cash transactions, and the next cash sale recorded at 7:46PM.

On July 20, 2018, the auditor ate lunch at Taxpayer's restaurant, and observed cash transactions that were not recorded as sales in the POS records. For example, he saw a $45.72 sale at 1:01 PM that was settled in cash, but found no corresponding transaction in the POS records other [than]a void at 1:03 PM (the POS system clock was 2 minutes fast). Further, the POS records only show 40 cash sales between $40 and $49 over thousands of operating hours, and it seems unlikely that in the one hour that the auditor was observing sales, he should witness a cash sale in this range if the POS records are accurate and reliable.

Audit found that Taxpayer's records were unreliable and insufficient to establish the measure of taxable receipts, and estimated taxable sales by treating all voids and gaps in check sequence numbers as deleted cash transactions, and only accepting tips recorded on Taxpayer's federal returns as valid, resulting in an adjustment to income of $. . . ($. . . from overstated tips, $. . . from voided transactions, and $. . . from gaps in check sequence numbers). Because this method would disallow valid void transactions, Audit set a ceiling on the adjustments by computing revenue using a cost of goods sold to total revenue ratio of 31 percent, a generally accepted ratio for restaurants. This reduced the adjustment by $. . . to $. . . [an amount approximately 56 percent less than original estimated sales amount].

Taxpayer petitioned for correction of the assessment, asserting that the assessment should be adjusted because Taxpayer did not underreport sales. It further asserted that the costs of goods methodology fails to consider relevant factors such as Taxpayer's use of high-quality ingredients, large portions, low prices, and potential employee theft; sales revenue is overestimated by considering valid voids generated automatically by the system when changing modes; missing check numbers are not generated by POS operators; and tips recorded in the POS systems should not be considered revenue.

Taxpayer provided a letter, declaration, and signed statement in support of its petition. The letter, dated September 27, 2019, and signed by . . . , President of . . . [POS system], explains as follows:

> In . . . [POS system], when a user opens a check, then navigates away from the check before any items have been submitted, the check will be automatically voided by the system. The restaurant's Security Log will display the description "VOID CANCELLED: by System" for a check that was voided by . . . [POS system]. If a check has been voided by an employee, the log will display the description "VOID" and may be followed by a reason for the void.

A declaration by . . . , the supplier of Taxpayer's . . . POS System, reads as follows (in pertinent part, underlining in original):

> 5. . . . The system has different modes such as online orders, take-out orders, dine in orders, etc. If any of the different modes are switched from one mode to the another, the system generates a void along with a zeroed amount and subsequently moves onto the next check number. . . . <u>This system generated voids cannot be created by individuals.</u> Many of the voids noticed from the data provided by . . . [Taxpayer's manager] are system generated voids, and not voids from individuals or restaurant employees.
> 6. . . . [Taxpayer's manager] mentioned that the system has been displaying check numbers that are not sequential. From the best of my understanding, there is not a way for such check numbers to be manually deleted.

A signed statement by . . . , Taxpayer's manager, reads as follows (in pertinent part, underlining in original):

> This is to address the issue of system-generated voids on our POS system. To clarify this further, these are not voids, but rather system-generated cancellations, and I will attempt to explain the difference and why this is occurring.
>
> If you look at the sales journal that I sent Mr. . . . , - voids are clearly marked on one of the columns. In these examples that were attached by Mr. . . . , you can see that some of these cancelled items have a "void" next to them. Others do not and these should be considered cancellations.
>
> As a failsafe protection for the restaurant owners, our POS system does not allow servers to just cancel out orders that were submitted to the kitchen. . . . We document ALL voids at the end of the night and reconcile them all as this is important for operations. These cancellations are especially just that, hitting an escape key, they zero out and compute a zero transaction. In this case, <u>nothing was ever sent to the kitchen and no money was exchanged</u>. . . .

> I apologize for the confusion our POS has caused. I can see and understand DOR's point of view on this, but the voids are system generated, not by our employees or myself. . . . This audit shed some light on areas we need to tidy up in our operations, like our inventory control and tip control; however, I can assure you there was no underreporting of our revenue by the company, or the employees and no taxes were ever underpaid.

ANALYSIS

Washington imposes a retail sales tax on each retail sale in this state. RCW 82.08.020(1). The term "retail sale" is defined to include sales of tangible personal property. RCW 82.04.050(1)(a). Taxpayer is selling prepared food and beverages, which are items of tangible personal property, and is making retail sales subject to retail sales tax. RCW 82.04.050; *see also* WAC 458-20-124 (The administrative rule regarding restaurants, cocktail bars, taverns and similar businesses.)

Washington imposes B&O tax for the act or privilege of engaging in business activities. RCW 82.04.220. The tax is measured by applying particular rates against the value of products, gross proceeds of sales, or gross income of the business as the case may be. RCW 82.04.220. The tax rate or rates applicable to a particular taxpayer depend on the type of activity or activities in which the taxpayer engages. Persons making retail sales are subject to retailing B&O tax on their gross proceeds of sales. RCW 82.04.250(1).

Businesses liable for Washington taxes have the responsibility to keep accurate and complete business records. RCW 82.32A.030(3); RCW 82.32.070. WAC 485-20-254 (Rule 254) repeats and clarifies these responsibilities. Rule 254(3) provides, in pertinent part:

> (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 and preserved. All of the taxpayer's records must be presented upon request by the department or its authorized representatives that 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.
>
> . . .
>
> (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.

RCW 82.32.100(1) provides that when taxpayers fail to provide records, "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; . . . ." 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).

The Department uses a broad range of methodologies to estimate tax liability. This includes estimating income based on records of wages of workers, and estimating cash sales based on an industry study of payment methods. Det. No. 15-0026, 34 WTD 373 (2015); Det. No. 15-0350, 35 WTD 291 (2016). Pursuant to RCW 82.32.100, the Department has the authority to estimate the tax in the manner it deems best, as long as it does so reasonably. Det. No. 99-341, 20 WTD 343 (2001).

First, we consider whether Taxpayers failed to provide suitable records such that the Department was correct in making estimated assessments. Taxpayer provided no original source documents or records for periods prior to September 7, 2016, despite the requirement under RCW 82.32.070 and Rule 254(3)(b)(i) that it keep such records. Instead, it provided monthly summary reports from its old POS system that are missing detail with regards to the underlying sales and are clearly insufficient to substantiate gross receipts. For subsequent periods within the audit period, Taxpayer did provide detailed electronic records from its subsequent POS system. However, we find a number of anomalies in Taxpayer's records:

- Taxpayer reported $. . . in taxable social security tips, but data from its POS systems show $. . . in tips, more than six times the amount reported on its federal returns. Taxpayer said that it reported tips on federal returns based on what its servers said they had received, but this does not explain Taxpayer's failure to report tips in reliance on the POS reports, which it now asks the Department to rely on in order to verify reported sales.

- The cash sales percent reflected in Taxpayer's records trends quickly downward, and Taxpayer has offered no explanation for this rapid change. It moves from 20 percent in January, 2014, to 8 percent in August, 2017. This is a drop of more than 50 percent in less than 4 years.

- The ratio of cash sales to total sales reflected in Taxpayer's records is very low. A 2010 BAI & Hitachi Study of Consumer Payment Preferences, dated January 25, 2011, shows cash payment averages of 55 percent at fast food restaurants, 33 percent at coffee shops, and 27 percent at restaurants. *See* Det. No. 15-0350, 35 WTD 291 (2016). However, Taxpayer's overall cash sales to total sales per the new POS system is only 10 percent. Taxpayer cites a study to support the reasonableness of 8 percent cash sales. *See* www.tsys.com/Assets/TSYS/downloads/rs_2016-us-consumer-payment-study.pdf (last accessed June 19, 2020). However, because it shows a cash preference for dine in restaurants at 18 percent and fast food at 33 percent, it does not support the 10 percent cash sales reflected in Taxpayer's records. *Id*.

- On the only days that show minimal gaps in check sequence numbers, the cash sales percent is 30 percent and 29 percent, roughly in line with the studies referenced above, indicating that gaps in check sequence numbers reflect unrecorded/unreported cash sales.

- Seven of the 100 largest cash transactions recorded in Taxpayer's records were on September 13, 2016, and June 27, 2018, the only days that lack a significant number of missing checks. It is unlikely that these sales would happen to fall on such days unless the days with large numbers of missing check numbers are also missing large cash sales. Taxpayer responds that some of the largest cash sales were on days where there are a large number of missing check numbers, but this does not explain why so many large cash sales occurred on these outlier days.

- The number of cash payments for sales over $40 is unreasonably small. Taxpayer's records show that there were only 62 cash payments, versus 5,398 credit card payments, for sales over $40. This is over a period of 22 months, when Taxpayer was open for business 564 days, indicating that only about 3 customers per month made cash payments on sales over $40. We find such a small number of $40 or more cash sales not credible.

- From September 7, 2016 through June 30, 2018, the POS system is missing 19,218 checks. Taxpayer explains that missing checks cannot be created by users, and are generated by the POS system. In is unclear, however, why a POS system designed to track sales would automatically generate missing check numbers, making tracking sales more difficult.

- On July 20, 2018, the auditor ate lunch at Taxpayer's restaurant, and observed cash transactions that were not recorded as sales in the POS records. Further, the POS records only show 40 cash sales between $40 and $49 over thousands of operating hours, and it seems unlikely that in the one hour that the auditor was observing sales, he should witness a cash sale in this range if the POS records are accurate and reliable.

- From September 7, 2016 through June 30, 2018, the POS system recorded 16,791 voided cash sales, but only 12,435 completed cash sales for $1 or more (sales under $1 only total $60). 13,598 of the voids are system generated voids, and 3,193 are non-system generated voids. Taxpayer avers that system generated voids should not be deemed sales, and provided an explanation for some observed transactions that do not comport with the POS record. For example, Taxpayer explains that Check No. 144 was "dine in," and changing the order to "take out" resulted in a system void of Check No. 145 and creation of Check No. 146. However, the data indicates that Check No. 144 and 146 are for entirely different orders, and we find Taxpayer's explanation unconvincing.

- Taxpayer's records show long gaps between completed cash sales. For example, on February 5, 2018, the records show a cash sale at 5:02PM, followed by 10 voided cash transactions, and the next cash sale recorded at 7:46PM. This indicates that there were a substantial number of actual cash sales that were voided.

In consideration of all the above anomalies, taken together, we find that the Taxpayer has failed to provide suitable records to establish its tax liabilities, and Audit was correct to issue an estimated assessment. The only remaining issue is whether the estimated assessment is reasonable. Audit capped the assessment using a 31-percent costs-of-goods-sold ratio, which effectively reduces the assessment to take into account imputed amounts that may not reflect actual sales. Taxpayer avers that this ratio is unreasonable and conflicts with its sales data, and explains that several studies cite a cost of goods sold ratio in the range of 28 to 40 percent. However, since Taxpayer's sales data absent adjustment is not suitable to verify Taxpayer's reported sales, conflict with that data is understandable, and Taxpayer has failed to establish that the estimated assessment is unreasonable.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 23rd day of June 2020.