

Cite as Det. No. 97-134R, 18 WTD 163 (1999)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of)	<u>F I N A L</u>
Assessment of)	<u>D E T E R M I N A T I O N</u>
)	
)	No. 97-134R
)	
...)	Registration No. ...
)	FY. . /Audit No. ...

- [1] RCW 82.32.070; WAC 458-20-254: RECORD KEEPING. Failure to keep adequate records prevents taxpayer from questioning Audit estimate of taxpayer's income where no additional evidence provided on appeal contradicts the estimate.
- [2] RCW 82.32.090(5); WAC 458-20-228; WAC 458-20-230: EVASION PENALTY. Evidence of drug addiction shows only the motivation for tax evasion, it is insufficient to overcome proof that taxpayer knew taxes were due, collected but did not remit retail sales tax trust funds, and under reported 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.

NATURE OF ACTION:

Taxpayer seeks reconsideration of Det. No. 97-134 in which an assessment for business and occupation (B&O) and retail sales taxes plus the 50% evasion penalty was upheld. During the audit period the taxpayer had a substantial drug problem.¹

FACTS:

Munger, (successor to Breen), A.L.J. -- The taxpayer, . . . , seeks reconsideration of Det No. 97-134. The facts from that determination will be repeated here along with new evidence raised on reconsideration and the Department of Revenue's (the Department) response to it.

The business records of the taxpayer were examined by the Department for the period January 1, 1992 through December 31, 1995. On July 31, 1996, an audit assessment was issued for a total of \$

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

. . . in tax, interest, and a 50% evasion penalty. At issue is the assessment of additional retailing B&O tax and the evasion penalty.

The taxpayer is engaged in the business of repairing automobiles. The assessment of additional retailing B&O tax resulted from the Department's finding that the taxpayer had vastly underreported his income during the audit period. The taxpayer contends that the estimates used by the Department to calculate his tax liability are overstated because his drug addiction prevented him from working for much of the audit period. The taxpayer contends that he borrowed money from family members to replace the lost income. In his original petition, the taxpayer suggested a lower estimate of his gross receipts.

The Department found numerous gaps and inconsistencies in the taxpayer's records. The Department found an increase in cash paid-outs during the audit period (as compared to prior years), but supposedly less income. Department personnel observed what appeared to be an unreported employee working for the taxpayer. However, there were no expenses recorded for the employee. There were numerous instances of cars being towed to the taxpayer's shop for repair when no income was recorded for the repairs. The Department detected 27 such instances. As for the taxpayer's contention that he had no bank account, the Department discovered three different accounts, including one in the name of "[the taxpayer's business name]" that appear to have been utilized by the taxpayer for business purposes during the time in question.

Due to the clear inconsistencies between the level of income reported by the taxpayer on his tax returns and the level of income indicated by other evidence collected by the Department, the evasion penalty was imposed. In relation to the penalty, the Department made the following observations in regards to the taxpayer:

1. You were actively in business and collecting the retail sales tax from your customers during the entire audit period.
2. Billing invoices were provided to substantiate the itemizing and collection of retail sales tax from the taxpayer's customers.
3. You filed "no business" excise tax returns for the Quarter 4, 1994 and Quarter 1, 1995 time periods. During this time you collected the retail sales tax from your customers and did not remit those trust funds to the department.
4. Throughout the entire audit period, your sales were substantially underreported.

On reconsideration the taxpayer has provided evidence of his completion of a drug treatment program in late 1994. Additionally, he has provided confirmation that relatives paid about \$7000 of his debts in late 1994, including some of the costs of his drug treatment program. In late 1994 his sister and brother-in-law loaned him \$3000 in cash for the expenses of the

treatment program. The Audit Division's response notes that none of the money loaned or paid by relatives for the taxpayer's bills was included in the Department's estimates of his income.

Copies of three checks were provided as samples of how he handled the [taxpayer business name] checking account. The checks are from April 1992, and include \$250 made out to cash and two checks totaling another \$250 made out to [a retail store]. The taxpayer contends that this proves the Department's method of estimating income (adding known cash expenditures to known cash deposits) is double counting some of his income. The Department's assessment, includes as income for April 1992, \$245 in cash expenditures and deposits of \$3,653. The Audit Division's response also indicates that the taxpayer's proposed lower estimate of income would not even have covered the cost of his drug habit.

The taxpayer's representative, on the evasion penalty issue, asserts that the taxpayer's lack of complete records is evidence of negligence on the taxpayer's part caused by drug addiction and that the taxpayer may have relied on ex-girlfriends for business matters and that he did not intentionally evade taxes.

ISSUES:

1. Whether the Department overestimated the taxpayer's income for purposes of calculating his tax liability.
2. Whether the taxpayer's vast underreporting of his income and collecting retail sales tax but not remitting the collected tax provides a basis for the imposition of the 50% evasion penalty.

DISCUSSION:

[1] The law clearly states that taxpayers have the responsibility to maintain suitable records as may be necessary for the Department to be able to determine the taxpayer's tax liability. Any person who fails to comply with this requirement shall be forever barred from questioning the correctness of any assessment of taxes for any period in which adequate records were not kept. See, RCW 82.32.070; WAC 458-20-254 (Rule 254).

The general requirement to maintain suitable business records for examination by the Department is found in RCW 82.32.070:

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.
.. Any person who fails to comply with the requirements of this section shall be forever

barred from questioning, in any court action or proceedings, the correctness of any assessment of taxes, made by the of revenue based upon any period for which such books, records, and invoices have not been so kept and preserved.

(Emphasis added.)

The taxpayer did not comply with most, if any, of the required practices. The taxpayer previously conceded his financial records were in a “mess.” Given these circumstances, we find the Department’s utilization of known cash deposits with known cash business expenditures to estimate the taxpayer’s income was more than reasonable in light of the seriously inadequate records. The taxpayer did not maintain adequate records during the audit period and, thus, is now barred from questioning the correctness of the assessment.

The additional records provided on reconsideration are not a basis for changing the Department’s methods of estimating income. In the case of the taxpayer’s bills being paid by relatives, the Department never counted these funds as a part of business income. Additionally, the April 1992 checks for cash and [to the retail store], without being linked to full documentation of the taxpayer’s business, do not prove that the Department double counted a small portion of the taxpayer’s income. There was no evidence that these same funds were the ones used for the \$245 in April cash business expenditures.

[2] The Department’s authority to impose the fifty percent evasion penalty is set forth in RCW 82.32.090(5) and WAC 458-20-228 (Rule 228).² WAC 458-20-230 (Rule 230) requires that the Department must demonstrate the evasion by clear, cogent, and convincing evidence which is objective and creditable.

The Department’s interpretation of the phrase “intent to evade” is set forth in Rule 230, which provides in part that:

Evasion involves a situation where the taxpayer knows a tax liability is due and the taxpayer attempts to evade detection through deceit, fraud, or other intentional wrongdoing.

Imposition of the evasion penalty requires proof of the following by clear, cogent, and convincing evidence that is both objective and creditable: (1) a tax liability which the taxpayer knows is due; and (2) an attempt by the taxpayer to escape detection through deceit, fraud, or other intentional wrongdoing.

The expense of the taxpayer’s drug addiction may have provided the motivation for the tax evasion, but no evidence has been provided that shows he was unable to form the intent to evade taxes. Indeed, the objective facts of this case clearly show that the elements of tax evasion have been established by the Department.

² These standards were discussed more thoroughly in Det. No. 97-134.

First, the taxpayer has indicated both by his conduct and his statements in his original petition that he clearly understood that his business activities were taxable. Retail sales tax was routinely collected at the correct rate from customers. The taxpayer seriously underreported his gross receipts on excise tax returns. In two cases the taxpayer filed “no business” excise tax returns while during this same period he collected retail sales tax on taxable transactions. In another he reported no retail sales while collecting retail sales tax from customers. Even more egregious is that the taxpayer did not remit the collected retail sales tax trust funds to the Department. We are not persuaded that this represents careless behavior by the taxpayer, instead it confirms he was intentionally evading his tax responsibilities.

DECISION AND DISPOSITION:

The taxpayer’s petition for reconsideration is denied.

Dated this 30th day of June 1998.