

Cite as Det. No. 18-0006, 38 WTD 149 (2019)

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. 18-0006  
 )  
... ) Registration No. . . .  
)

[1] RULE 185; RCW 82.26.200 – OTHER TOBACCO PRODUCTS – UNLICENSED DISTRIBUTORS – DISTRIBUTORS ON TRIBAL LAND – TOBACCO PRODUCTS RETAILER'S LICENSE – TOBACCO PRODUCTS DISTRIBUTOR'S LICENSE. Sellers of tobacco products in Washington State who are not licensed both as retailers and distributors of tobacco products are liable for tobacco tax when they purchase such products from unlicensed distributors or any other persons not licensed under chapter 82.26 RCW, to be held, handled, or distributed in this state. A taxpayer with a tobacco retailer's license who made purchases from an unlicensed distributor located on tribal land, was liable for tobacco tax because the taxpayer did not also have a tobacco distributor's license.

[2] RULE 185; RULE 254; RCW 82.26.130; RCW 82.32.070, RCW 82.32.100 – OTHER TOBACCO PRODUCTS – RECORDKEEPING REQUIREMENTS – REASONABLE ESTIMATE. Tobacco retailers who fail to keep invoices as required under chapter 82.32 RCW are liable for the tax owed on any uninvoiced tobacco products, but not penalties and interest except in certain circumstances. A taxpayer who failed to keep and present required records was assessed tax based on an estimate. The estimate was found to be reasonable, because it was based on the taxpayer's available records (such as invoices for other purchases, prior filed excise tax returns, and other records); the advertised prices of similar products; and the written observations and inventories made at the taxpayer's place of business by a state Liquor and Cannabis Board officer.

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.

LaMarche, T.R.O. – A Washington-based corporation that owns and operates a convenience store that makes retail sales of . . . tobacco products . . . , disputes the assessment of [the tobacco products] tax on certain purchases it admittedly made from unlicensed tobacco distributors for which it did

not pay [the] tax. Taxpayer argues that the estimate that served as the basis for the tax assessment is manifestly unreasonable. We deny the petition.<sup>1</sup>

## ISSUES

- 1) Under RCW 82.26.130, [RCW 82.26.200(1),] and WAC 458-20-185, is Taxpayer liable for [the tobacco products] tax[, commonly referred to as the “other tobacco products” tax or OTP,<sup>2</sup>] on its purchases from unlicensed distributors, when Taxpayer failed to retain and produce invoices and other records for its purchases?
- 2) Under RCW 82.32.070, RCW 82.32.100, and WAC 458-20-254, did the Department reasonably estimate the amount of OTP tax due on Taxpayer’s purchases of OTP products from unlicensed distributors?

## FINDINGS OF FACT

. . . (Taxpayer) is a Washington-based corporation that owns and operates a convenience store in . . . Washington. Its activities include retail sales of OTP. Taxpayer holds a Washington State tobacco products retailer’s license, but does not hold a wholesaler’s or distributor’s license.

Taxpayer states that its owner . . . (Owner) . . . worked in the business before buying it in 2009. In a declaration provided with the petition, Owner states that he made purchases for Taxpayer from an unlicensed distributor, but only during the period from February 2015 through March 2016, and not for the entire audit period.

On March 3, 2016, the Washington State Liquor and Cannabis Board (LCB) performed a routine inspection of Taxpayer’s business. During the first field visit, the LCB officer spoke to Owner, who was present during the inspection, and asked about the frequency and location of Taxpayer’s purchases. Owner stated that he made purchases from . . . , both of which are Washington-licensed distributors of tobacco products. However, upon inspection of Taxpayer’s storage area, the LCB officer located OTP inventory bearing the label of an unlicensed distributor located . . . in Washington.

The LCB officer requested invoices for the inventory on hand, including that which was purchased from unlicensed distributors. Owner indicated he did not have the records, but that he could provide them at a later time. Owner indicated he purchased cigars from the unlicensed distributor, but when asked, could not provide an accurate timeline for his purchases. The officer conducted a photographic inventory of Taxpayer’s tobacco merchandise and left the premises.

The LCB officer returned to the premises on March 21, 2016, to pick up the invoices discussed during the prior visit. However, Owner stated he did not have the invoices, and asked the officer to return in a week. The officer returned on March 30, 2016, and Owner provided several months of invoices for purchases he made from licensed distributors, but indicated he had no invoices for

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

<sup>2</sup> [The reference to “other” in OTP distinguishes the tax from the cigarette tax, which is addressed in RCW 82.24.]

any of the inventory he purchased from unlicensed distributors. During the visit, the officer noted additional OTP from an unlicensed distributor; the officer confiscated that inventory.

The LCB referred the case to the Department of Revenue (Department), and the Department's Taxpayer Account Administration (TAA) commenced an audit of Taxpayer's sales of tobacco products for the 51-month period from January 1, 2012, through March 31, 2016 (Audit Period). The LCB provided to TAA a referral packet (Case Referral Packet) containing information about the inspection . . . [and the LCB estimate of tobacco purchases from unlicensed distributors].

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After receiving the Case Referral Packet, the Department's tax examiner called the LCB officer to clarify information in the packet. The officer stated that based on the information available to him, his estimate of the amount of Taxpayer's total monthly purchases was a reasonable one. The officer indicated that although his estimate was based on seven purchases of OTP products yearly, Taxpayer made OTP purchases more frequently, which he estimated to be an average of 1.5 purchases monthly. The OTP prices the officer used in his estimate were based on wholesale prices advertised on the website of a tobacco distributor based in Washington State.

After speaking to the LCB officer, the tax examiner called Taxpayer's tax preparer . . . (CPA), on July 27, 2016, to discuss the case, and left a message requesting a return call. CPA did not respond to the message. Shortly thereafter, the examiner called and spoke with Owner, who stated he was not able to speak at that time, but indicated he would return the call in five minutes. Owner did not return the call. The examiner then sent a secure message to Taxpayer requesting OTP purchase records, giving Taxpayer the opportunity to provide the records in the event that the records were kept at a location other than its place of business. On August 3, 2016, CPA replied, again indicating that Taxpayer did not have any invoices for the disputed purchases of OTP.

On August 5, 2016, the tax examiner sent a secure message to Taxpayer requesting an OTP purchase schedule and records from all of its tobacco products vendors for the periods in question. The message also informed Taxpayer of the pending estimated tax assessment.

**CPA Estimate.** CPA responded shortly after receiving the tax examiner's August 5 message, but did not provide OTP purchase schedules or invoices for purchases during the Audit Period from licensed distributors. For the first time, CPA asserted that Taxpayer had made purchases from unlicensed distributors for only 14 of the 51 months in the Audit Period. CPA provided an estimate of tax due in a document entitled "Cigar[s] Purchased From . . . Shop." The estimate indicates no tax liability for the tax years 2012 through 2014, for January 2015, and for the periods from April through August 2016, based on Taxpayer's claim that it only made purchases from unlicensed distributors for the periods from February 2015 through March 2016.

For the periods from February 2015 through March 2016, the tax liability in CPA's estimate was as follows:

Tax Year 2015. A total of \$ . . . , which consisted of the following periods and amounts. February: \$ . . . , March: \$ . . . , April: \$ . . . , May: \$ . . . , June: \$ . . . , July: \$ . . . , August: \$ . . . , September: \$ . . . , October: \$ . . . , November: \$ . . . , December: \$ . . .

Tax Year 2016. A total of \$ . . . , consisting of the following periods and amounts. January: \$ . . . , February \$ . . . , March: \$ . . .

The Department rejected the CPA's estimate and did not use it when estimating Taxpayer's liability, for the following reasons. First, Taxpayer and CPA did not provide any purchase records, point of sale records, or other supporting documentation to substantiate CPA's estimate of purchases from unlicensed distributors. Second, Taxpayer failed to provide proof to support its claim that it made purchases from unlicensed distributors for only a 14-month period. Third, CPA's estimate used prices averaging less than half of those used in the LCB officer's estimate, which were based on actual wholesale OTP prices listed on the website of a Washington-based tobacco products distributor. CPA provided no explanation why the prices he used in his estimate were substantially lower.

Fourth, CPA made the assumption that all sales were of cigars, and lumped estimated purchase amounts together. CPA did not separate out amounts by product type (e.g., cigars priced over \$0.68, moist snuff, pipe tobacco, etc.), each of which is taxed at a different rate. Finally, the estimates CPA provided were not corroborated by the actual amount of inventory the LCB officer found on Taxpayer's shelves at the time of the LCB inspection.

**Department Estimate.** The Department found that because the LCB officer had observed the premises, spoke with Owner, obtained the receipts from Taxpayer for purchases from licensed distributors, and noted the actual inventory when making his estimate, the LCB Case Referral Packet contained the best information available upon which to begin the Department's own estimate.

The Department calculated its estimate, using as a basis the officer's estimated purchase frequency of 1.5 times per month, and calculated an estimated monthly average of OTP purchases, based on the officer's statements, his inventories of product on hand, and the invoices Taxpayer provided. The Department also took into consideration the information Taxpayer had reported on its combined excise tax returns during the Audit Period. The Department excluded from its estimate items for which Taxpayer provided invoices, including those for OTP product on hand during the LCB inspection. The Department applied the estimated monthly average purchase amount to each month in the Audit Period, and based its assessment on that estimate.

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Based on its estimate, the Department issued an assessment on October 28, 2016, Document No. . . . , totaling \$ . . . . The total consisted of \$ . . . in OTP tax (for cigars costing less than \$0.69), Litter Tax of \$ . . . , \$ . . . in OTP Tax on moist snuff (for amounts 1.2 oz. or less), \$ . . . in OTP tax (for cigars costing \$0.69 or more), and interest of \$ . . . . Taxpayer did not pay the assessment, but timely filed a petition.

During the hearing, Owner asserted that, although he noticed profit margins were larger when making sales of products purchased from unlicensed distributors, he was unaware that tax had not been paid on those sales and, as a result, failed to take into consideration OTP tax when reselling the products to customers. Owner stated that he was not aware that his purchases were noncompliant with state law until he learned this information in March 2016, from the LCB and CPA. Owner further indicated that he remembered the dates of his purchases because of certain events that occurred on or near the times he made the purchases. However, other than Owner's statement included with the petition, and his statements at the hearing, Taxpayer has provided no other evidence, including invoices or other sales documents, to establish that he purchased from unlicensed distributors for only 14 months.

Taxpayer argues that the Department's estimate is manifestly unreasonable because the methodology describes no boundaries, and because the purchase and sales amounts set forth in the audit schedules are provided with no explanation of how they were derived. Taxpayer notes that the Examiner's Detail states that the estimates were based on the LCB officer's recommendation, but asserts that the LCB documentation it obtained through a public records request did not contain any recommendations of the LCB officer.

## ANALYSIS

### 1. OTP Tax Liability

Washington imposes a tax on the distribution and sale of tobacco products in this state.<sup>3</sup> RCW 82.26.020(1). A tobacco products "retailer" is defined under RCW 82.26.010(17) as "any person engaged in the business of selling tobacco products to ultimate consumers."

Pursuant to RCW 82.26.200(1), a retailer that obtains tobacco products from an unlicensed distributor, or other person that is not licensed under chapter 82.26 RCW, "must be licensed both as a retailer and a distributor under this chapter and is liable for the tax imposed under RCW 82.26.020 with respect to the tobacco products acquired from the unlicensed person that are held for sale, handling, or distribution in this state." *See also* [WAC 458-20-185(205) (Rule 185(205))]. Here, Taxpayer holds only a retailer's license, and admits to making purchases from unlicensed distributors. Therefore, Taxpayer is liable for OTP tax for purchases from those distributors, where OTP tax has not been paid.

Tobacco product retailers are subject to specific recordkeeping requirements, as follows:

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<sup>3</sup> We note that the term "tobacco products" excludes "cigarettes," which are separately defined in RCW 82.24.010(2), and by reference, in RCW 82.26.010(6). "Tobacco products" are defined by RCW 82.26.010(21) to include:

[C]igars, cheroots, stogies, periques, granulated, plug cut, crimp cut, ready rubbed, and other smoking tobacco, snuff, snuff flour, cavendish, plug and twist tobacco, fine-cut and other chewing tobaccos, shorts, refuse scraps, clippings, cuttings and sweepings of tobacco, and other kinds and forms of tobacco, prepared in such manner as to be suitable for chewing or smoking in a pipe or otherwise, or both for chewing and smoking, and any other product, regardless of form, that contains tobacco and is intended for human consumption or placement in the oral or nasal cavity or absorption into the human body by any other means, but does not include cigarettes as defined in RCW 82.24.010.

- (1) Every retailer shall procure itemized invoices of all tobacco products purchased. The invoices shall show the seller's name and address, the date of purchase, and all prices and discounts.
- (2) The retailer shall keep at each retail outlet copies of complete, accurate, and legible invoices for that retail outlet or place of business. All invoices required to be kept under this section shall be preserved for five years from the date of purchase.
- (3) At any time during usual business hours the department, board, or its duly authorized agents or employees may enter any retail outlet without a search warrant, and inspect the premises for invoices required to be kept under this section and the tobacco products contained in the retail outlet, to determine whether or not all the provisions of this chapter are being fully complied with. If the department, board, or any of its agents or employees, are denied free access or are hindered or interfered with in making the inspection, the registration certificate issued under RCW 82.32.030 of the retailer at the premises is subject to revocation, and any licenses issued under this chapter or chapter 82.24 RCW are subject to suspension or revocation by the department.

RCW 82.26.080.

A tobacco product retailer who fails to keep required invoices of all tobacco products purchased is liable for the tax owed on any un invoiced tobacco products. RCW 82.26.130(2).

The Department's administrative rule implementing tobacco product recordkeeping requirements is . . . Rule 185(301), which provides, in pertinent part:

Books and records. An accurate set of records showing all transactions related to the purchase, sale, or distribution of tobacco products must be retained. RCW 82.26.060, 82.26.070 and 82.26.080. All records must be preserved for five years from the date of the transaction.

(a) Distributors. Distributors must keep at each place of business complete and accurate records for that place of business. The records to be kept by distributors include itemized invoices of tobacco products held, purchased, manufactured, brought in or caused to be brought in from without the state or shipped or transported to retailers in this state, and of all sales of tobacco products. The itemized invoice for each purchase or sale must be legible and must show the seller's name and address, the purchaser's name and address, the date of sale, and all prices and discounts. Itemized invoices must be preserved for five years from the date of sale.

(b) Retailers. Retailers must secure itemized invoices of all tobacco products purchased. The itemized invoice for each purchase must be legible and must show the seller's name and address, the purchaser's name and address, the date of sale, and all prices and discounts. Itemized invoices must be preserved for five years from the date of sale. Retailers are responsible for the tax on any tobacco products for which they do not have invoices.

Rule 185(301).

In addition, as a general matter, all taxpayers in this state have the obligation to generate, maintain, and preserve, for five years, the records necessary to establish their tax liability. RCW 82.32.070(1); WAC 458-20-254. As explained in RCW 82.26.120, all of the provisions of chapter 82.32 RCW “shall have full force and application with respect to taxes imposed under the provisions of this chapter.”

Although the Department requested records on multiple occasions, and gave Taxpayer many opportunities to provide those records, Taxpayer failed provide the documentation required under RCW 82.26.130(2) and Rule 185(301) to show that OTP tax was paid on its purchases from unlicensed distributors. Therefore, Taxpayer is liable for the applicable tax on those purchases, pursuant to RCW 82.26.130(2) and Rule 185(301). Accordingly, we deny the petition as to this issue.

Having determined that the tax is due, we turn now to whether the estimate of tax in the assessment was reasonable.

## 2. Estimated Tax Liability

As we discuss above, a retailer who fails to keep required invoices of all tobacco products it purchases is liable for the tax owed on any un invoiced tobacco products. RCW 82.26.130(2). As previously stated, retailers of tobacco products have specific recordkeeping requirements imposed by Rule 185(301).

For administrative purposes, the provisions of chapter 82.32 RCW apply to tobacco product taxes. RCW 82.26.120. If any person fails or refuses to make records available for examination, RCW 82.32.100(1) authorizes the Department to proceed “in such manner as it may deem best, to obtain facts and information on which to base its estimate of the tax.” Once the Department obtains the available facts and information, the Department “shall proceed to determine and assess against such person the tax and any applicable penalties or interest due.” RCW 82.32.100(2); Det. No. 15-0148, 35 WTD 10 (2016). Where a taxpayer does not provide adequate records to provide a basis for the exact amount of income subject to tax, the Department is required to determine the tax due based on the best information available. RCW 82.32.100(2); 35 WTD 10.

Here, Taxpayer admits that it did not retain records for its purchases of tobacco products from unlicensed tobacco dealers. Because Taxpayer did not have the records required under RCW 82.26.130(2), the Department was required to determine the tax due based on the best information available. . . . *Id.*

Pursuant to its authority under RCW 82.32.100(2), the Department estimated Taxpayer’s tax liability based on the following: 1) several months of invoices for legitimate purchases; 2) documents supporting the average amount of Taxpayer’s purchases overall; 3) existing inventory; 4) sales Taxpayer reported on its combined excise tax returns during the Audit Period; 5) conversations with Owner, including his own admissions; 6) LCB field observations of Taxpayer’s place of business, and an inventories made at the time of the inspection; and 7) discussions with

the LCB officer with regard to his estimates of the average amount and frequency of OTP purchases.

The Department excluded from its estimate amounts Taxpayer was able to establish with proper invoices, and used average OTP prices provided by the LCB, which are based on actual market prices. The Department found its estimate to be consistent with Taxpayer's combined excise tax returns filed during the Audit Period.

We agree that the Department properly disregarded CPA's estimate. The estimate was flawed, and was disregarded for the following reasons. CPA provided no supporting documentation for his estimate, failed to break out products by type, and provided no explanation as to why the prices he used for the estimate were only approximately 50% of the actual wholesale prices published by a tobacco products distributor in this state.

We concur with the Department's decision to disregard Owner's assertion that he made purchases from unlicensed distributors for only 14 months during the Audit Period. First, Owner provided no records to substantiate his statement. Second, Owner was unable at the time of the inspection in March 2016 to provide a timeline establishing when he made the disputed purchases, and did not make the 14-month claim until approximately five months later, in August 2016. These factors cast doubt on the accuracy of the Owner's statement.

Third, Owner initially stated to the LCB officer that he made purchases from . . . , both licensed distributors, but did not acknowledge the purchases he had made from an unlicensed distributor until the LCB officer located inventory from an unlicensed distributor in Taxpayer's storage area. We also note that Taxpayer retained and provided invoices from its OTP purchases from licensed distributors, but *not a single one* from unlicensed distributors. This indicates that, prior to the LCB inspection, Taxpayer was aware that its purchases from unlicensed distributors were different than those from licensed distributors, and that it treated the records for each kind of purchase differently. The evidence indicates that it is more likely than not that Taxpayer, by failing to retain and produce the receipts for *all* purchases from unlicensed distributors it made during the Audit Period, intended to hide the fact that it made those purchases in order to avoid the associated liability. Contrary to Taxpayer's assertions, the evidence does not suggest Owner's actions were those of a person who unwittingly made purchases from unlicensed distributors unaware of the fact that there were liabilities associated with those purchases, and who only discovered that fact in March 2016.

. . . In addition to his time as an employee, Owner ran the business for eight years between his time of purchase and the LCB inspection. We do not find credible that Owner worked as an employee in a business that purchased and resold OTP, and later owned and operated that business for approximately seven years prior to the LCB inspection, but was unaware of Washington's OTP laws with regard to purchases from unlicensed distributors. The fact that Owner failed to retain and produce even a single invoice for purchases from unlicensed distributors for the entire Audit Period, yet retained those from licensed sellers during that time, indicates that he was fully aware of the difference between those two types of purchases throughout the Audit Period. This belies Owner's assertion that he made the disputed purchases unknowingly and for only a relatively short period of time.

As we discuss in Det. No. 13-0302R, 33 WTD 572 (2014) and Det. No. 14-0281, 34 WTD 056 (2015), an abuse of discretion occurs when a decision rests on untenable grounds or is manifestly unreasonable. (Referring to *Mayer v. Sto Indus., Inc.*, 156 Wn.2d 677, 684, 132 P.3d 115 (2006).) Here, the Department made many attempts to obtain records from Taxpayer, and gave Taxpayer many opportunities to provide the records required under law, yet Taxpayer failed to produce those records. When making the estimate, Audit used Taxpayer's own records for purchases from licensed distributors, its excise tax returns, and other actual data when possible. Prices were based on actual published wholesale prices, and the amounts and frequency of OTP purchases were based on a combination of Taxpayer's own records, inventory on hand, and the LCB officer's observations during the course of his on-site inspections. We also note that prior to issuing the assessment, Audit compared its estimate to Taxpayer's combined excise tax returns filed during the Audit Period, and found the estimate to be corroborated by the sales Taxpayer reported.

We conclude that the Department used the best information available, and reasonably relied on that information for purposes of estimating OTP tax liability, thereby meeting the requirements of RCW 82.32.100(2). We do not find the grounds for the estimate to be untenable, or the assessment based on that estimate to be manifestly unreasonable. Accordingly, we deny the petition as to this issue.

#### DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 10th day of January 2018.