

REDACTED DECISION – DK# 20-066 CORP. NET INCOME, 20-067 COMB. SALES & USE

**BY: CRYSTAL S. FLANIGAN, ADMINISTRATIVE LAW JUDGE
SUBMITTED FOR DECISION ON JANUARY 19, 2022
DECISION ENTERED ON JULY 15, 2022**

FINAL DECISION

On December 26, 2019, the Tax Accounting Administration of the West Virginia State Tax Department (hereinafter “Tax Commissioner” or “Respondent”) issued two assessment letters (Letter Id# L1746554816 and Letter Id# L0643968960) to Acme, Inc., dba Billy’s Club (hereinafter “Billy’s” or “Petitioner”). These two assessments were issued pursuant to the authority of the Respondent, granted to him by the provisions of Chapter 11, Article 10 *et seq.*, of the West Virginia Code. The December 26, 2019, assessments had been made against the Petitioner for combined sales and use tax for tax periods January 1, 2016, through August 31, 2019, in the amount of \$_____ in tax, \$_____ in interest, and \$_____ in additions for a total of \$_____. The corporate net income assessment was issued for the tax periods from January 1, 2016, through December 31, 2018, and includes \$_____, interest of \$_____ and additions of \$_____ for a total of \$_____.

The Petitioner timely filed its Petition for Reassessment with this Tribunal on February 12, 2020. Subsequently, a notice of hearing on the petition was sent to the parties and in accordance with the provisions of West Virginia Code Section 11-10A-10, a hearing was held on August 5, 2021, in Charleston, West Virginia by Google Meet, and the matter became ripe for decision after post hearing briefs.

FINDINGS OF FACT

1. Acme, Inc., is a West Virginia corporation that operated Billy’s Club (hereinafter “Billy’s”) in Alpha Town, Beta County, West Virginia. TR. 73.

2. Billy's is a bar that sells alcoholic beverages, food, limited video lottery machines, and conducts unlicensed cash raffles which are also known as "tip jars." *Id.*
3. John X (hereinafter "Mr. X") was the President of Acme and 100% shareholder during the audit period. TR. 43-44.
4. Neither Mr. X nor any employee or independent contractor who worked at the bar testified at the evidentiary hearing.
5. John CPA (hereinafter "Mr. CPA") is a CPA who has been the Petitioner's accountant for 20 years. TR. 43. Mr. CPA was the Petitioner's sole witness.
6. Mr. CPA relied upon daily control sheets and bank statements for the Petitioner's revenue but did not rely upon z tapes or invoices. TR. 45-48, 63-64, 75.
7. He did not know how the numbers for the daily control sheets were derived. TR. 146.
8. The Petitioner was selected by the Tax Commissioner for a field audit.
9. The field audit was conducted for a week at Mr. CPA's office. TR. 11.
10. The auditors were not provided the merchant statements and cancelled checks from the ATM account. TR. 105.
11. The auditors found that several credit card sales were not recorded in the Petitioner's cash register Z-tapes. TR. 111-118. Respondent's Ex. Nos. 1 and 2.
12. The auditors were provided daily control sheets that lacked the drinks given away. TR. 133.
13. Due to these missing records, the auditors then examined the sales tax remittances in light of the claimed cost of goods sold (hereinafter "COGS"). TR. 122.

14. The Petitioner's COGS for the audit period was 67% for tax year 2016, 96% for tax year 2017, and 82% for tax year 2018. TR. 20.
15. COGS is typically 50% of sales. TR. 23.
16. Due to the high COGS and the lack of records, the auditors used a "drink count" method where purchases of wine and liquor were made to determine the amount of sales. TR. 123-124.
17. The Petitioner's records do not include the exact number of drinks that were given away to customers to encourage them to continue gambling at the video lottery machines. TR. 21,27, 42, 46, 57-58, 64, 70-71, 133.
18. The Petitioner grossed approximately \$_____ dollars from the video lottery machines during the assessment period. TR. 23-24, Pet.'s Opening Brief, p. 14.
19. The auditors also discovered unreported, additional income from the raffles. The Petitioner was also conducting cash raffles without a license to do so. TR. 35, 61-63.
20. The business income from the tip jars and alcohol sales were used to support the assessments. TR. 83,88, 128, 133.
21. No food sales were included in the audit or assessment. TR. 39-40, 127.

DISCUSSION

The issues in this matter are 1) whether the Petitioner was accurately collecting and remitting combined sales and use tax to the Respondent during the assessment time periods; and 2) whether the Petitioner's corporate net income tax returns were accurately filed and paid. In this matter both parties agree regarding the controlling law, and neither party argues that any of the statutory or regulatory provisions are ambiguous.

The West Virginia Code provides that “[f]or the privilege of selling tangible personal property . . . and for the privilege of furnishing certain selected services . . . the vendor shall collect from the purchaser the tax as provided under this article . . . and shall pay the amount of tax to the Commissioner in accordance with the provisions of this article . . .” W. Va. Code Ann. § 11-15-3(a) (West 2010). “‘Vendor’ means any person engaged in this state in furnishing services taxed by this article or making sales of tangible personal property” W. Va. Code Ann. § 11-15-2(26) (West 2010).

Likewise, the Code provides that “The purchaser shall pay to the vendor the amount of tax levied by this article which is added to and constitutes a part of the sales price, and is collectible by the vendor who shall account to the State for all tax paid by the purchaser.” W. Va. Code Ann. § 11-15-4 (West 2010). Section 4 also lays out the record keeping requirements for vendors tasked with collecting sales tax.

- (b) The vendor shall keep records necessary to account for: (1) The vendor’s gross proceeds from sales of personal property and services; (2) The vendor’s gross proceeds from taxable sales; (3) The vendor’s gross proceeds from exempt sales; (4) The amount of taxes collected under this article, which taxes shall be held in trust for the state of West Virginia until paid over to the tax commissioner

.....

Id.

Section 14a of Title 110, Series 15 of the West Virginia Code of State Rules also lays out the record keeping requirements of businesspeople in the state, “Every person doing business in the State of West Virginia . . . shall keep complete and accurate records as are necessary for the Tax Commissioner to determine the liability of each vendor or vendee for consumers sales and use tax purposes.” W. Va. Code R. § 110-15-14a.1 (1993). Each record kept by persons doing business in West Virginia “shall consist of the normal books of account ordinarily maintained by the average prudent person engaged in the activity in question” *Id* at 14a.2. Additionally, “the Tax Commissioner may use a detailed auditing procedure or a sample and projection auditing

method to determine tax liability.” *Id.* at 14b.2. Under 14b.3 of this section, “a sample and projection auditing method is appropriate if” . . . “the taxpayer’s records are so detailed, complex, or voluminous that an audit of all detailed records would be impractical or unreasonable.” *id.* at 14b.3.1; “the taxpayer’s records are inadequate or insufficient, so that a competent audit for the period in question is not otherwise possible” *id.* at 14b.3.2; or “the cost of an audit of all detailed records to the taxpayer or the State will be unreasonable in relation to the benefits derived, and sampling procedures will produce a reasonable result” *id.* at 14b.3.3. Further, “[I]f records are inadequate to accurately reflect the business operations of the taxpayer, the auditor will determine the best information available and will base the audit report on that information.” *Id.* at 14b.4.

In this matter, the Petitioner operates a bar in Alpha Town, West Virginia that sells alcohol, food, has LVL machines, and provides raffle jars. The Petitioner was audited by the West Virginia State Tax Department for combined sales and use tax and corporate net income tax. The auditing department conducted a field audit where they were at Mr. CPA’s office for one week reviewing 18 boxes of the Petitioner’s documents. During the audit, several deficiencies were found in the Petitioner’s recordkeeping, including merchant statements and cancelled checks from the ATM account, missing credit card sales from the cash register z tapes, and missing documentation regarding drinks that were given away. The auditors determined that the Petitioner’s sales tax returns were suspiciously low compared to the cost of goods sold. A sales tax assessment was issued for unreported sales, along with an assessment for income attributed to the unreported sales and income from the unlicensed raffles.

The Petitioner argues that the assessment overestimates the amount of actual drink sales. Billy’s operates LVL machines and bar employees would give away drinks to incentivize patrons to continue using the machines. According to Billy’s, the assessment failed to consider drinks given away, spillage, shrinkage, etc., and as such, these categories should not be subject to

combined sales and use tax. However, Billy's did not provide any records for the amounts that were given away, spilled, etc., as testified by auditor Charlotte [REDACTED] during the hearing:

ATTORNEY [REDACTED]: Now, did you ask any of the employees of the Petitioner why you found those numbers, those cost of goods sold percentages to be so high?

MS. [REDACTED]: Not the employees, no. I don't believe I had got to this point when I did the site visit.

ATTORNEY [REDACTED]: Okay.

MS. [REDACTED]: I think I asked [Mr. CPA], I believe.

ATTORNEY [REDACTED]: And what did [Mr. CPA] tell you?

MS. [REDACTED]: I'm going to say if memory serves me, he said that they give a lot of beer and liquor away.

ATTORNEY [REDACTED]: Okay. And did he have something to prove that to you?

MS. [REDACTED]: No.

ATTORNEY [REDACTED]: He didn't?

MS. [REDACTED]: There was nothing that showed me how much he gave away.

Evidentiary Hearing Transcript p. 21.

Furthermore, Mr. CPA testified that no records existed of the drinks that were given away:

ATTORNEY [REDACTED]: Okay. So my question ---. Okay. So I probably could have shortened it considerably. So my question is, you did not use actual records from the bar based on beer and drinks and wine, food, and whatever else that was given away to come up with this \$_____ for tax year 2016. Correct?

[MR. CPA]: No, because we didn't (sic) records, I made that calculation.

ATTORNEY [REDACTED]: Okay. That's ---.

[MR. CPA]: My assumption.

Evidentiary Hearing Transcript p. 66-67.

Mr. CPA also confirmed to the Tribunal regarding the Petitioner's lack of records:

JUDGE FLANIGAN: Okay. And you said, and I want to make sure that I understand this, that there are no records to differentiate what was given away in order for patrons to continue to play the machine. Is that right?

[MR. CPA]: That's correct.

Evidentiary Hearing Transcript p. 73-74.

The auditor compared three credit card sales with the corresponding cash register z-tape where the credit card sales were missing. This was an indication to the auditor that all sales were not being entered into the cash register. The credit card sales and the z-tape should match and when they did not match, the auditor saw this as a red flag that not all the sales were being rung up.

Because the credit card sales and z tapes did not match and Petitioner did not provide the auditor any record of what was given away, the auditor then examined the COGS by reviewing the available records for the 2016-2018 tax years and those amounts compared to sales were 67%, 96%, and 82% respectively. Video lottery sales were **not included** in this COGS and the auditor testified to these issues as follows:

ATTORNEY [REDACTED]: Now, it says in here, if I'm not mistaken, that you had some indication that there was an unreported income because the cost of goods sold were so high. Is that correct?

MS. [REDACTED]: Yes. That was another indication. Yes.

ATTORNEY [REDACTED]: Another indication, other than the fact that you were not able to trace the Z-tape sales in credit cards to the income. Is that right?

MS. [REDACTED]: Yes. That was the first. Yeah. And this was the second.

ATTORNEY [REDACTED]: Okay. Now, let me make sure I understand this. You're telling me, then, at the top of page seven of the Interrogatory Responses, Exhibit 2 ---

MS. [REDACTED]: Yes.

ATTORNEY [REDACTED]: --- that the cost of goods sold in 2016 was 67.66 percent. Is that correct?

MS. [REDACTED]: The cost of goods sold for beer, food, liquor, and soda as opposed to the reported sales was 67.66 percent. I believe in his general ledger, he had --- he never added in his video lottery stuff. So I just did a cost of goods sold just with his sales, and leaving out all the video lottery stuff.

ATTORNEY [REDACTED]: Okay. And same inquiry as to 2017.

MS. [REDACTED]: Yes.

ATTORNEY [REDACTED]: That the cost of goods sold was 96.43 percent. Is that correct?

MS. [REDACTED]: Yes.

ATTORNEY [REDACTED]: And for 2018, it was 82.29 percent. Is that right?

MS. [REDACTED]: Yes.

Evidentiary Hearing Transcript p, 20.

The auditors normally see a COGS of 50% and so the significantly increased COGS was a source of concern. So, the auditors then conducted a “drink count” audit. The drink count audit utilizes the total amount of beer and liquor purchased and then the auditors determine the number of single drinks that would be sold from those purchases. TR. 123-124. The auditors based this information on records from [REDACTED] Distributing, [REDACTED] Distributing, and [REDACTED] Distributing for beer sales.

The Petitioner sold beer for \$2.00 through the week and \$3.00 on the weekends and imported beer for \$3.50. The auditor used an average price of \$2.50 per beer which reduced the Petitioner’s overall beer sales. Tr. 127. The Petitioner sold one ounce shot liquor drinks for \$5.00. TR. 123.

The general ledger had additional purchases that could not be backed up with liquor invoices. Based upon the best information available, the auditor calculated each shot at 1.5 ounces,

instead of one ounce shots which works to the Petitioner's favor. TR. 127. Mixed drinks were sold for \$4.00 during happy hour for bottom well drinks which was the only time liquor was sold for less than \$5.00 and top shelf liquor drinks were sold for between \$7.00-\$9.00 a drink. The auditor gave the liquor drinks at \$5.00 which also worked to the Petitioner's favor.

The bar manager informed the auditor that 5% of the beer and liquor were being given away. The auditor reduced the beer sales by 6% to account for the 5 % being given away and 1% spillage. Most of the beer was sold in a bottle or can and not from the tap. The auditor also allotted a 5% reduction of the liquor as being given away and an additional 5% for spillage. Thus, giving them total of a 10% reduction for liquor sales. The Petitioner failed to ever produce any records regarding drink give aways or spillage.

The Respondent argues that the lack of these records, the usually high COGS, and the missing credit card receipts not appearing on the z tapes (indicating that they were not rung up) necessitates using the best information available. We agree. This Tribunal finds that without an accurate record of what was given away, the auditors had to rely upon the information that was available to them.

The Petitioner argues that the combined sales and use tax assessment is wrong but cannot overcome the hurdles of having no record of drinks given away, missing credit card sales from its z tapes, and an excessively high COGS. Instead, the Petitioner argues that pulling only two days for three years of records is inadequate. However, those two days indicated missing records and several inaccuracies. In this matter, the Petitioner would have the Respondent audit every possible record for three years which he is not obligated to do under the Regulations. W.Va. CSR 110-15-14b3-14b3.3; *See e.g. Irby v. Zheng*, 2021 WL 2253264.¹

¹ In *Irby v. Zheng*, 2021 WL 2253264, the West Virginia Supreme Court of Appeals expressed concerns about the auditors using only one day of surveillance to determine three years of combined sales and use tax. That concern is well taken on this Tribunal. However, the regulations do not require a specific number

The auditors often gave the Petitioner favorable drink prices and gave them the same percentages the Petitioner's bartender told them or even gave them more favorable percentages. The auditors went from one hurdle to the next in a series of steps to arrive at the combined sales and use tax assessment. This Tribunal is hard pressed to believe that this methodology used by the auditors is arbitrary and capricious. The auditors reviewed the records for a week and had discussions with the accountant, found missing credit card sales on the z tapes, reviewed the COGS, and then spoke with the bar manager. After these several steps, the auditors could finally arrive at a combined sales and use tax assessment of \$____. The Petitioner even agrees that it owes \$____ (an approximate difference of \$____) in underlying combined sales and use tax. *See*, Petitioner's Opening Brief, p.19, CPA Testimony, TR.56.

This Tribunal finds that the auditors followed the tax regulations, used the best information available, and provided many favorable calculations to the Petitioner. Accordingly, the Tribunal finds the Petitioner's argument fails to meet its burden as to the combined sales and use tax assessment.

The Petitioner also alleges that the corporate net income tax assessment was incorrect because the sales of the unreported drinks should not be included in the revenue. The Petitioner continues to argue that any drinks not accounted for were simply given away and should not be included as income. Again, the Petitioner had no records to support this as discussed *supra*, and accordingly, we find this argument to be without merit.

The Petitioner also received income from unlicensed raffle sales. The Petitioner's tax returns did not include all raffle income as Mr. CPA testified to during the hearing:

[MR. CPA]: Are you talking about the tip income?

of days to be sampled for an audit. In the instant matter, the auditors relied upon a two-day sample and then, utilized a drink count method which worked to the Petitioner's favor as discussed, *supra*.

ATTORNEY [REDACTED]: Yeah. I think so. Yes. I can't read my writing. Okay. Yes. Yes. Did you report ---? You didn't report all of the tip income. Okay. I thought that said --- I thought it said TP income. Okay. Must be tip income. Yes. Did you say that or did I mishear?

[MR. CPA]: I said I didn't know ---. That part of the tip income was reported in the vending, but I'm sure not all the tip income ---

ATTORNEY [REDACTED]: Okay. Yeah.

[MR. CPA]: --- was reported because it didn't get into the bank account.

Evidentiary Hearing Transcript p. 67.

Mr. CPA could not confirm that the raffle ticket monies were tracked and included in the corporate net income tax returns because the owner would use the cash to pay for expenses at the bar, such as payroll. TR. 61-62. Clearly, just because raffle money was paid out does not mean that it wouldn't be considered as income. It would be revenue just like any other money that customers spent at Billy's and if that money was spent on various costs, then it would be deducted as such. The Petitioner appears to be saying "hey, this money came in the door, but I had to spend on expenses, so it doesn't really count as income" but we find this argument as clearly incorrect and without merit. Not only did the Petitioner fail to include raffle income on its corporate tax returns, but it appears to be operating these raffles without a raffle license.²

The Petitioner also puts forth the argument that Mr. X, the sole owner of Billy's, often loaned money to it for operating expenses.³ The Petitioner argues the loans would reduce the Petitioner's revenue and ultimately, its corporate net income tax. This Tribunal has heard this argument in other cases. In those matters, the Petitioner will testify about the loans made and provide copies

² The Respondent brought up a concerning issue regarding the Petitioner operating raffles without a license. This Tribunal does not have jurisdiction over licensing for raffles but notes that the Petitioner is a for profit organization and that raffle licenses are only issued to nonprofit organizations. W. Va. Code §§ 47-24-1 and 47-21-4.

³ This Tribunal notes that the Respondent did not issue a personal assessment against Mr. X. Thus, making his personal bank statements, on their own have very little, if any, relevancy to this case.

of checks or electronic transfers from their personal checking account to the business account. However, that is not what the Petitioner provided to this Tribunal. The Petitioner put forth a stack of Mr. X's personal bank statements with no testimony from Mr. X and then asked us the question of "where did all the money go if it wasn't spent on the business?"

There were no banking transactions from Mr. X's account to the business account proving where the money went, nor did Mr. X testify. This money could have been spent on virtually anything and without his testimony or banking transactions confirming these loans, we would be completely speculating. Accordingly, we find this argument to be a red herring and completely without merit.

The Respondent's Attorney, Timothy [REDACTED] during the evidentiary hearing reduced the amount owed by \$_____ and the corresponding interest and additions as follows:

There was a small adjustment that we agreed to make to the corporate net income tax amount, which I think was ---. I didn't write it down. I meant to do that earlier and I forgot. It looks like there was an adjustment made of income tax due adjusted. That means we would have to go back and recalculate it for the proper time periods. But it does look like we are in agreement of adjusting the income tax down by \$_____. So from \$_____, we would remove from that another \$_____. That's just the tax. Of course, that would also flow through, we would recalculate the interest and the additions

Evidentiary Hearing Transcript p.2.

CONCLUSIONS OF LAW

1. It is the duty of the Tax Commissioner to see that the laws concerning the assessment and collection of all taxes and levies are faithfully enforced. *See* W. Va. Code Ann. § 11-1-2 (West 2010).

2. "The Tax Commissioner shall collect the taxes, additions to tax, penalties and interest imposed by this article or any of the other articles of this chapter to which this article is applicable." W. Va. Code Ann. § 11-10-11(a) (West 2010).

3. Article Fifteen of the West Virginia Tax Code imposes a general consumer's sales and service tax, for the privilege of selling tangible personal property or custom software and for the privilege of furnishing certain selected services, and it is the duty of the vendor to collect the same. *See* W. Va. Code Ann. § 11-15-1 and § 11-15-3 (West 2010).

4. "The purchaser shall pay to the vendor the amount of tax levied by this article which shall be added to and constitute a part of the sales price, and shall be collectible as such by the vendor who shall account to the State for all tax paid by the purchaser." W. Va. Code Ann. § 11-15-4 (West 2010).

5. "(b) The vendor shall keep records necessary to account for: (1) The vendor's gross proceeds from sales of personal property and services; (2) The vendor's gross proceeds from taxable sales; (3) The vendor's gross proceeds from exempt sales; (4) The amount of taxes collected under this article, which taxes shall be held in trust for the state of West Virginia until paid over to the tax commissioner" W. Va. Code Ann. § 11-15-4 (West 2010).

6. "To prevent evasion, it is presumed that all sales and services are subject to the tax until the contrary is clearly established." W. Va. Code Ann. § 11-15-6(b) (West 2010).

7. "Every person doing business in the State of West Virginia . . . shall keep complete and accurate records as are necessary for the Tax Commissioner to determine the liability of each vendor or vendee for consumer sales and use tax purposes." W. Va. Code R. § 110-15-14a.1 (1993).

8. If, when auditing taxpayer records, said records are, ". . . inadequate to accurately reflect the business operations of the taxpayer, the tax auditor will determine the best information available and will base the audit report on that information." W. Va. Code R. § 110-15-14b.4 (1993).

9. The Petitioner failed to account for and remit to the Tax Commissioner all the sales taxes collected from its customers.

10. The records which were provided to the Tax Commissioner were not complete and accurate enough to determine the Petitioner's liability for consumer sales and use tax purposes. Nor were they adequate to accurately reflect the corporate net income tax.

11. The Tax Commissioner was not clearly wrong or arbitrary and capricious when he determined that the best information available, as that term is used in Section 14b.4, to reflect the Petitioner's sales.

12. "If the Tax Commissioner believes that any tax administered under this article has been insufficiently returned by a taxpayer, either because the taxpayer has failed to properly remit the tax, or has failed to make a return, or has made a return which is incomplete, deficient or otherwise erroneous, he may proceed to investigate and determine or estimate the tax liability and make an assessment therefor." W. Va. Code Ann. § 11-10-7(a) (West 2010).

13. In a hearing before the West Virginia Office of Tax Appeals on a petition for reassessment, the burden of proof is upon the Petitioner to show that any assessment of tax against it is erroneous, unlawful, void or otherwise invalid. *See* W. Va. Code Ann. § 11-10A-10(e) (West 2010); W. Va. Code. R. §§ 121-1-63.1 and 69.2 (2003).

14. The Petitioner in this matter has not met its burden of showing that the combined sales and use tax assessment and the corporate net income tax assessment against it were erroneous as discussed above.

DISPOSITION

WHEREFORE, it is the final decision of the West Virginia Office of Tax Appeals that: the combined sales and use tax assessment issued against Acme, Inc., dba Billy's Club on December 26, 2019, for a total liability of \$_____ is hereby **AFFIRMED**.

The corporate net income tax issued against Acme, Inc., dba Billy's Club for the reduced underlying tax liability of \$_____ along with the corresponding reduction in interest and addition is hereby **AFFIRMED**.⁴

Interest continues to accrue on these unpaid taxes until fully paid. W. Va. Code Ann. § 11-10-17(a) (2010).

WEST VIRGINIA OFFICE OF TAX APPEALS

By: _____
Crystal S. Flanigan
Administrative Law Judge

Date Entered

⁴ The Tax Commissioner's attorney reduced the underlying tax amount by \$_____ during the evidentiary hearing as discussed *supra*. Therefore, the new tax amount is \$_____ (\$_____-\$____=\$_____).