

Cite as 6 WTD 171 (1988)

BEFORE THE INTERPRETATION AND APPEALS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition )	<u>D E T E R M I N A T I O N</u>
For Correction of Assessment of)	
)	No. 88-264
)	
. . . )	Registration No. . . .
)	Tax Assessment No. . . .
)	
)	

**RULE 199:** ACCOUNTING METHODS. A taxpayer who regularly employs the cash basis of accounting in keeping its books and is a service business not required to collect retail sales tax may report on the basis of cash receipts without an adjustment for accounts receivable.

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.

TAXPAYER REPRESENTED BY: . . .

DATE OF HEARINGS: September 10, 1987 and June 7, 1988

NATURE OF ACTION:

The taxpayer petitions for correction of an assessment after an audit of the taxpayer's records holding that it is on the accrual basis of accounting for business and occupation tax purposes.

FACTS AND ISSUES:

Norton, A.L.J. -- The taxpayer is a service business which is not required to collect the retail sales tax. As a result of an audit (January 1, 1983 through December 31, 1986), Tax Assessment No. . . . was issued for tax of \$ . . . . The taxpayer accepted the audit results in the amount of \$ . . . and paid that on July 17, 1987.

The taxpayer provides professional consulting services and bills its clients based on its hourly service fees. The taxpayer's general ledger and regular accounting system is on the cash basis. Reports to various states, Internal Revenue Service, banks, owners,

and employees are on the cash basis. There is an additional record or register which is maintained on a separate computer program referred to as the "Billing Register." In this program is accumulated the worked hours at billing rates of the various employees and recorded to the various clients and projects. This information is used in determining the "billings" to the various clients and what amounts are not to be billed. After the client is billed, further adjustments to the register can be made to reflect client's objections to the bill and adjustment to it. Further adjustments are made to reflect billings written off as uncollectible. The information in the "Billing Register" is used for internal management purposes only.

The auditor determined that this "Billing Register" created an accrual set of records and under Department's Determination No. 84-245A, the taxpayer must report under the accrual method.

In issue is whether the taxpayer is required to report on the accrual method.

#### DISCUSSION:

RCW 82.04.080 provides that:

Gross income of the business means the value proceeding or accruing by reason of the transaction of the business engaged in . . . . (Underscoring ours.)

"Value proceeding or accruing" is defined by RCW 82.04.090 to mean:

. . . the consideration, whether money, credits, rights, or other property expressed in terms of money, actually received or accrued. The term shall be applied, in each case, on a cash receipts or accrual basis according to which method of accounting is regularly employed in keeping the books of the taxpayer. (Underscoring ours.)

The statutes above are implemented by administrative rules. Such rules have the same force and effect as the law. RCW 82.32.300. WAC 458-20-199 (Rule 199) concerns accounting methods. It states in part:

METHOD ONE, CASH. Only persons engaged in a strictly cash business will be permitted to make returns on a cash basis . . . .

METHOD TWO, ACCRUAL BASIS. Persons operating their business on the accrual basis must report under the business and occupation tax and the retail sales tax for each tax reporting period the gross proceeds from all cash sales made during the period, together with the total amount of charge sales during the period.

METHOD THREE, CASH RECEIPTS, ACCOUNTS RECEIVABLE ADJUSTMENT. Persons doing a charge business who do not record such charges as sales at the time the sale is made may report for tax purposes under method three.

Persons may report and pay the tax on the amount received as cash sales plus all cash received on accounts during each period. . . .

Persons engaged in service business activities who are not liable for the collection of the retail sales tax are not required to adjust accounts receivable at the end of the tax year.

Under Rule 199, the taxpayer must report under method two or three since he has more than a strictly cash business.

The key question is whether the accounting system is accrual. If so, then method two is required.

Since the auditor relied on Determination No. 84-245A which incorporates most of Determination No. 84-245, its facts merit our examination. The taxpayers in that case were syndicators and broker-dealers of limited partnerships. They kept books and records on both the cash and accrual basis. They have reported to Internal Revenue Service for federal income tax purposes on a cash basis. In addition, many internal management reports were done on a cash basis. On the other hand, audited financial statements were prepared on the accrual basis which were submitted to investors and lenders. The determination concludes that accrual basis was used.

Method two of Rule 199 is required if the taxpayer used the accrual method of accounting. The accrual method records a transaction when it is completed regardless of when the cash or other consideration is received. When there is a charge and no receipt of cash, the accrual accounting system recognizes that there has been created an asset (accounts receivable) and corresponding income.

It must be recognized that in any business where there are charges, the business must have records to monitor or control those charges until paid. The factual determination before us is whether the taxpayer by its records has recognized accounts receivable and the accompanying income. If so, it has created an accrual system and method two of Rule 199 must be used.

In this case, the taxpayer has shown that the information from the "Billing Register" was used for internal management information only. Its general ledger (foundation of the accounting system) and financial statements were maintained on the cash basis (without recognition of the charges as assets or income). It is the

representations to persons outside of the business entity that distinguishes Determination No. 84-245A and this case. In that Determination the taxpayer used his accrual basis financial statements to lenders and its investors. In this situation, the taxpayer's financial statements to lenders and others outside of management were on the cash basis. Taxpayer had not recognized the accounts receivables and the income it represents and is not on the accrual basis.

Therefore, taxpayer is entitled to use method three of Rule 199. Method three provides for taxation based on the cash received without any year-end adjustment where the taxpayer is a service business not required to collect retail sales tax.

#### DECISION AND DISPOSITION:

The taxpayer's petition is granted. The file is remanded to the Department's Audit Section for issuance of an amended assessment in line with the holding in this Determination, which will be due on the date indicated thereon.

DATED this 8th day of July 1988.