

Cite as Det. No. 15-0171, 35 WTD 330 (2016)

BEFORE THE APPEALS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition for Correction of )	<u>D E T E R M I N A T I O N</u>
Assessment of )	
) )	No. 15-0171
) )	
... )	Registration No. . . .
) )	

[1] RULE 254; RCW 82.32.070: RECORDS – CREDIT MEMOS. Credits are excluded from the measure of sales where the taxpayer incorrectly uses credit memos to adjust amounts reported and fails to provide contemporaneously recorded, reasonable explanations and documentation to establish that the memos reflect legitimate adjustments.

[2] RULE 228; RCW 82.32.090(5): NEGLIGENT PENALTY – SPECIFIC REPORTING INSTRUCTIONS. The negligent penalty applies where the taxpayer's disregard of specific reporting instructions contributes to the deficiency, and nothing in the record shows that the taxpayer made a good faith effort to comply with the instructions.

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, A.L.J. – A corporation engaged in selling, renting, and repairing heavy equipment; selling aggregate; and providing hauling for hire (Taxpayer) appeals the assessment of retail sales tax on grounds that the measure of tax should be reduced by credit memos. Taxpayer also appeals the negligent penalty on grounds that it did not disregard specific reporting instructions. We deny the petition.<sup>1</sup>

### ISSUES<sup>2</sup>

1. Whether, under RCW 82.32.070, Taxpayer has provided adequate records to support an adjustment to the measure of retail sales tax.

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

<sup>2</sup> Taxpayer asserts that the Department failed to accept a Machinery and Equipment (M&E) exemption certificate in error. Taxpayer's Appeals Statement, Page 9. Because Audit made an adjustment for the exemption in the post assessment adjustment issued on January 13, 2015, we do not address this issue.

2. Whether, under RCW 82.32.090(5), Taxpayer is subject to the negligent penalty when it failed to follow instructions to prepare and preserve records in an organized manner, make records available on a timely basis, and that finance charges are subject to tax.

### FINDINGS OF FACT

Taxpayer is a Washington corporation that sells, rents, and repairs heavy equipment; sells aggregate; and hauls for hire. On June 14, 2012, the Department of Revenue's (Department) Audit Division (Audit) began field work on a partial audit to review Taxpayer's income and asset purchases for the period January 1, 2008 through December 31, 2011.

Audit began by reconciling sales reports to the amounts that Taxpayer reported on its excise tax returns. The reconciliation showed that Taxpayer had substantially underreported revenue. Taxpayer provided the report that it used to file its excise tax returns, but that report failed to explain the discrepancies with the sales reports. Taxpayer then provided invoice registers, which Audit attempted to reconcile with the sales reports. Audit discovered that some invoices were not on the sales reports, some credit memos on the sales reports were not on the invoice registers, and some credit/debit memos on the invoice registers were not on the sales reports. Further, invoice registers reflected adjustments regardless of when the adjustments were made, and voided invoices did not appear on sales reports regardless of when the voids occurred. For example, some 2008 invoices were "voided" in 2010 or 2011 and had disappeared from the sales reports. Taxpayer explained that many of the invoices to support credit memos could not be provided as once the system voids them they can no longer be retrieved or printed, and that credit memos were by default back-dated to the date of the invoice. Audit examined accounts receivable adjustment reports, and found that most credit memos or "voids" lacked explanation or description and that many credit memos were reversals of finance charges that were not mentioned in sales reports or invoice registers.

Taxpayer's records were not kept in an organized manner and made available on a timely basis,<sup>3</sup> and Taxpayer made multiple errors in reporting its receipts. Taxpayer failed to report service and other activities B&O tax on its receipts of finance charges. Taxpayer reported sales of exempt manufacturing machinery and equipment, sales to the US Government, and sales to customers operating in interstate commerce as wholesale sales. Taxpayer failed to report interstate sales instead of reporting and deducting the sales. Taxpayer reduced sales for barter transactions and payments that it received. It also reduced sales for finance charges and retail sales tax that were never included in sales totals, and for trade-ins on sales that had already been deducted.

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<sup>3</sup> Taxpayer was unable to provide sufficient documentation during the initial statutory period, and Audit extended the deadline twice. Taxpayer asserts that Audit was inconsistent with requests for documentation resulting in delay. Taxpayer provided a January 7, 2013, email exchange between Taxpayer and Audit in which Taxpayer wrote, in pertinent part, "[C]ould you confirm that a printed credit memo with an invoice and amount is adequate? Most of the credit memos will only have that information." Audit responded, "A printed credit memo with an invoice attached should be adequate. I can't guarantee there won't be an exception but I wouldn't expect any." However, invoices were generally not attached to the credit memos, and this email does not establish that Audit agreed to accept credit memos lacking description or explanation and shared responsibility for the delay.

Taxpayer made extensive use of credit/debit memos to adjust the amounts that it reported, many of which were issued in error. During the audit period, Taxpayer recorded 1,289 credit and/or debit memos related to sales, rental, or repair invoices, not including 506 credit memos strictly related to finance charges. In 2010, Taxpayer adjusted or reversed 31% of its invoices via credit/debit memos. For the entire audit period, Taxpayer adjusted or reversed an average of 18% of its invoices with credit/debit memos. Of the 1,289 credit/debit memos, Taxpayer confirmed that 113 credit memos with a total value of \$ . . . were created for barter transactions or payments received. Taxpayer also issued credit memos for warranty work, even though Taxpayer received payment for the work from manufacturers.

Taxpayer explains that the memos are necessary to adjust records for customer returns, billings entered under the wrong customer or department, bills not paid in full, agreed upon price reductions, duplicate billings, cancelled billings (to maintain business relationships), bad debt, and weather or furlough-related down-time. Audit, however, did not allow adjustments for credit memos that were not adequately documented.

On September 27, 2013, after allowing extensions of deadlines to provide documents, Audit assessed Taxpayer \$ . . . , which included \$ . . . in retail sales tax. Audit assessed retail sales tax on income reconciliation differences caused by insufficient documentation of exempt sales, undocumented credits to sales, and adjustments to sales that should have been applied to other accounts.

Taxpayer then contacted Audit stating that it was gathering more documents. Audit granted an extension for payment of the assessment, and reviewed additional documents offered to support exempt retail sales and credit adjustments.

On March 3, 2014, Audit issued an adjusted assessment for \$ . . . (Post Assessment Adjustment, or PAA, No. 1). This is comprised of \$ . . . in retail sales tax, \$ . . . in motor transportation tax, \$ . . . in a 10% negligent penalty, \$ . . . in a 5% assessment penalty, \$ . . . in audit interest, and \$ . . . in additional interest, less payment of \$ . . . .

On March 27, 2014, Taxpayer appealed the assessment.<sup>4</sup> On August 18, 2014, Taxpayer delivered a box of records to Audit containing supporting records for credit memos, M&E transactions, and bad debt deductions, supplemented by additional information to support bad debts on November 13, 2014. Taxpayer also submitted an Appeal Statement with exhibits, followed by the first page of a 2011 Form 1120S showing \$ . . . in bad debts, and sample documents (comprised mostly of invoices, credit memos, accounts receivable detail, and handwritten notes) to demonstrate duplicate/incorrect billings, business relationships (to justify credit memos allegedly issued in support of such relationships), weather-related down-time, time delays in adjusting bills, adjustments to billings, and bad debts.

After reviewing the additional documents, on January 13, 2015, Audit adjusted the assessment down to \$ . . . (PAA No. 2), comprised of \$ . . . in retail sales tax, \$ . . . in service and other

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<sup>4</sup> We do not address Taxpayer's appeal of the 5% assessment penalty because the penalty was not assessed in the subsequent adjustment, discussed *infra*. We note that Audit made no adjustment to the wholesaling and retailing B&O tax classifications on grounds that the difference between the two classifications is immaterial.

activities business and occupation (B&O) tax,<sup>5</sup> \$ . . . in motor transportation tax, \$ . . . in 10% negligent penalty, \$ . . . in audit interest, and \$ . . . in additional interest from October 29, 2013 to February 12, 2015, less payment of \$ . . . .

Audit assessed the 10% negligent penalty on grounds that Taxpayer had disregarded specific written instructions from a prior audit where Taxpayer had made the same errors and Audit had told Taxpayer how to correctly report. In the prior audit, Taxpayer also failed to provide adequate documentation, failed to report finance charges, and reported exempt retail sales under the wholesaling B&O tax classification. On September 23, 2009, in connection with this prior audit, Audit issued Detail of Differences and Instructions to Taxpayer that reads as follows (in pertinent part):

Due to lack of records provided, including resale certificates and deduction information, certain assumptions were made in determining the amount of tax due. WAC 458-20-254 requires every person liable for payment of excise taxes to prepare and preserve all books of record in an organized manner. The records shall include all federal, state, and local tax returns and reports and all schedules or work papers used in their preparation.

Upon request by the Department of Revenue all books, records, and invoices shall be made available for examination on a timely basis. It must be possible to trace amounts recorded in your books of record back to your original sales or purchase invoices or other documents whether or not such amounts are taxable.

\* \* \*

The instructions provided in this report . . . constitute “specific written instructions” within the meaning of RCW 82.32.090.

\* \* \*

For future reporting purposes, sales to consumers are reported under the retailing and retail sales tax classification. This would include sales to manufacturers presenting a manufacturers sales and use tax certificate, sales to Native Americans, the U.S. Government, and qualified non residents. Persons presenting an ICC permit are taxable under the Retailing of Interstate Transportation Equipment tax classification.

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WAC 458-20-109 explains that amounts charged in addition to the selling price and designated as finance charges, carrying charges, service charges, penalties, or interest charges are taxable under the Service and Other Activities tax classification.

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<sup>5</sup> The service and other activities B&O tax is on finance charges not included in the previous assessments because Taxpayer did not provide Profit and Loss Reports showing these receipts from finance charges until December 4, 2014.

On November 17, 2010, Taxpayer executed Closing Agreement No. . . . with the Department in connection with this prior audit. Taxpayer agreed to provide consideration for reduced liability as follows (in pertinent part):

In consideration of this reduced tax liability, Taxpayer agrees in the future to follow the reporting instructions contained in the Auditor's Detail of Differences and Instructions to the Taxpayer. . . These instructions constitute "specific written instructions" within the meaning of RCW 82.32.090, and failure to follow these instructions will subject the taxpayer to the additional ten percent penalty mandated by that section.

#### ANALYSIS

Taxpayers have a duty to maintain their records in such a manner that their tax liabilities can be determined. RCW 82.32.070. This includes a specific obligation to generate, maintain, and preserve records and documentation necessary to establish tax liability. RCW 82.32.070(1); WAC 458-20-254(3)(b) (Rule 254). Taxpayers must keep and preserve suitable records, and make them available for examination by the Department for five years. RCW 82.32.070; RCW 82.32A.030.

WAC 458-20-254 ("Rule 254") sets forth specific requirements for a taxpayer to maintain and disclose books, records, and other sources of financial information to the Department. Rule 254(3) states, in relevant part:

(a) Every taxpayer liable for a tax or fee imposed by the laws of the state of Washington for which the department of revenue has primary or secondary administrative responsibility . . . must keep complete and adequate records from which the department may determine any tax liability for such taxpayer.

(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, preserved, and presented upon request of the department or its authorized representatives which 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.

(Emphasis added.) Taxpayer explains that it reported on an accrual basis and used credit memos to legitimately adjust its records as necessary, and asserts that Audit failed to accept valid credit memos resulting in an inflated measure of assessed retail sales tax. Audit disallowed credit memos not adequately supported by explanation and documentation, and Taxpayer admits that many of the credit memos that it had entered were for taxable barter transactions and payments received, which are clearly incorrect adjustments to the measure of sales and properly excluded by Audit.<sup>6</sup> Because Taxpayer erred by using credit memos to adjust amounts reported and failed to provide contemporaneously recorded, reasonable explanations and documentation to establish that the memos at issue reflect legitimate adjustments, we find that the memos at issue are not credible, and conclude that Audit was correct in excluding the credits from the measure of sales.<sup>7,8</sup>

Taxpayer also argues that Audit improperly assessed the negligent penalty. RCW 82.32.090(5) imposes the penalty for disregarding specific reporting instructions as follows (in pertinent part):

If the department finds that a taxpayer has disregarded specific written instructions as to reporting or tax liabilities . . . the department must add a penalty of ten percent of . . . the additional tax found due if there is a deficiency because of the failure to follow the instructions. A taxpayer disregards specific written instructions when the department has informed the taxpayer in writing of the taxpayer's tax obligations and the taxpayer fails to act in accordance with those instructions . . . The department may not assess the penalty under this section upon any taxpayer who has made a good faith effort to comply with the specific written instructions provided by the department to that taxpayer . . . Specific written instructions may be given as a part of a tax assessment, audit, determination, closing agreement, or other written communication, provided that such specific written instructions apply only to the taxpayer addressed or referenced on such communication. Any specific written instructions by the department must be clearly identified as such and

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<sup>6</sup> Taxpayers must keep records demonstrating amounts of gross receipts and sales from all sources, including barter transactions. Rule 254(3)(b). In Det. No. 98-133, 18 WTD 153 (1999), we explained that the measure of tax in a barter agreement is “the amount of consideration ‘actually received or accrued’ [which] includes the value of the property or services a taxpayer receives in lieu of any monetary payment for such services or property.”

<sup>7</sup> Taxpayer explains that Audit disallowed credit memos for bad debts in error. Audit examined documentation provided in August and November, 2014, and made adjustments where Taxpayer provided documentation substantiating bad debts that were written off during the audit period and had not been recovered. This included the example provided by Taxpayer in Exhibit F to the Department.

<sup>8</sup> Taxpayer asserts that Audit erred in including loan payments in the measure of retail sales tax. Taxpayer explains that its customer defaulted on a dealer guaranteed installment contract for purchase of equipment, and a promissory note to secure payment of an accounts receivable balance (memorialized in error using a Retail Installment Contract and Security Agreement form), and after Taxpayer paid back the bank, it had the customer execute two new notes to secure payment, and payments on those notes were included by Audit in the measure of tax. Audit asked for documentation to support the amounts paid to the bank on the defaulted loans, but never received anything to support the dollar value of the defaulted loans other than new retail installment contracts that Taxpayer claims are actually loans. We conclude that Taxpayer has not established that these amounts were loan payments rather than sales receipts, and thus decline to remove the amounts from the measure of retail sales tax.

must inform the taxpayer that failure to follow the instructions may subject the taxpayer to the penalties imposed by this subsection.

WAC 458-20-228 (Rule 228) is the administrative rule that explains penalties. Rule 228(5)(e) provides that the negligent penalty at issue applies if “all or any part of a deficiency resulted from the disregard of specific reporting instructions.”

Audit issued written instructions to Taxpayer in the previous audit, and in Closing Agreement No. . . . , Taxpayer agreed that “[t]hese instructions constitute “specific written instructions” within the meaning of RCW 82.32.090, and failure to follow these instructions will subject Taxpayer to the additional ten percent penalty mandated by that section.” Closing Agreement No. . . . , Page 2.

Audit instructed Taxpayer that it must prepare and preserve all books of record in an organized manner and make records available on a timely basis. This is consistent with Rule 254(3)(b) requiring taxpayers to “prepare and preserve all records in a systematic manner conforming to accepted accounting methods and procedures” and present the records upon request. Taxpayer did not follow the instructions as evidenced by its inconsistent, inadequately documented, and backdated books of record, and multiple delays in providing these records. Audit also instructed Taxpayer that finance charges are subject to tax under the service and other activities B&O tax classification, but Taxpayer failed to report finance charges and Audit assessed tax on these charges in PAA No. 2 after Taxpayer provided figures.

Taxpayer asserts that because the instructions do not address credit memos and bad debts, “which is the majority of this audit,” the instructions are not applicable to the assessment at issue. Taxpayer’s Appeal Statement, Page 11. While the instructions do not specifically address credit memos and bad debts, they do include instructions to prepare and preserve all books of record in an organized manner, make records available on a timely basis, and report finance charges. Taxpayer disregarded these instructions, which contributed to the deficiency. Because all or part of the deficiency resulted from disregarding these instructions, and nothing in the record shows that Taxpayer made a good faith effort to comply with the instructions, we sustain the penalty.

#### DECISION AND DISPOSITION

Taxpayer’s petition is denied.

Dated this 7th day of July, 2015.