Cite as Det. No. 94-084, 14 WTD 240 (1995).

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

In the Matter of the Petition	)	D E T E R M I N A T I O N
For Correction of Assessment of	)	
	)	No. 94-084
	)	
. . .	)	Registration No. . . .
	)	FY. . ./Audit No. . . .

RULE 197: ACCOUNTING METHODS -- RECOGNITION OF INCOME. Progress payments made to contractors are taxable at the time of receipt unless it can be shown that the payments were received as trust funds.

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:

The taxpayer protests the assessment of the retailing business and occupation (B&O) tax and retail sales tax measured by the advance payments and progress payments received on construction contract work. The actual taxability of these amounts is not questioned; rather, the taxpayer contends that such taxes are not due for payment to the Department of Revenue (Department) until completion of the work and final payment by its customer.[1]

FACTS:

Lewis, A.L.J. -- The taxpayer's business records were audited for the period January 1, 1989 through December 31, 1991. A petition protesting audit tax and interest was timely filed. The disputed tax and interest arose from the Department's decision that the taxpayer should recognize as income and report progress

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

payments for tax purposes when received, rather than waiting until the completion of the contract.

The taxpayer derives its income from residential construction and remodel and speculative home building. During the audit period the taxpayer recorded income for financial and federal tax purposes using the completed contract method.

The Department determined that the taxpayer should have recognized as income the progress payments when received. This change requires the taxpayer to recognize its income sooner. This change, over the long run, would not change the actual tax liability if the tax rate remains the same. However, since interest is charged on tax deficiencies, the change in accounting methods results in interest charges to the taxpayer.

ISSUE:

Whether income from a construction contract may be deferred until completion of the contract when the taxpayer is receiving progress payments based on the estimated work completed?

DISCUSSION:

[1] The taxpayer has requested a ruling as to when it must recognize and pay taxes on its construction income. WAC 458-20-197 (Rule 197) is the administrative code rule that discusses when tax liability arises. It states in general that:

> (1) Gross proceeds of sales and gross income shall be included in the return for the period in which the value proceeds or accrues to the taxpayer.

WAC 458-20-197(4) also addresses its special application to contractors. It states:

> Value accrues for a building or construction contractor who maintains his accounting records on the accrual basis, as of the time the contractor becomes entitled to compensation under the contract.
>
> (a) If by the terms of the contract the taxpayer becomes entitled to compensation upon estimates as the work progresses, value, to the extent of such estimates, accrues as of the time that each estimate is made and the balance at the time of completion of the work or the final estimate.
>
> (b) If by the terms of the contract the taxpayer becomes entitled to compensation only upon the completion of the work, value accrues as of the earlier of the completion of

> the work, or, any use of the facilities being constructed, or, 60 days after the facility is substantially complete.

The taxpayer has provided two samples of its contracts. One contract was used for construction of new custom homes. Its section 3(A) addresses payment. It reads in pertinent part:

> . . . [The taxpayer], shall receive from the lender as a draw on or before the tenth day of each month, a percentage amount of the total amount of the total price equal to the percentage of work completed as shall be determined by the lender, or by means of a percentage progress chart which [the taxpayer] will supply to the Owner. Owner hereby authorizes the lending institution to pay all such draws in the percentage amounts determined by either method specified in this paragraph.

The other contract was used for remodels and additions of existing structures. Its section 3(A) addresses payment. It reads in pertinent part:

> The Owner shall pay [the taxpayer] the sum of $. . . including Washington sales tax in the amount of $. . . plus any additional amounts as specified elsewhere in this agreement according to the following payment schedule: . . . . If any draw or payment is not received by [the taxpayer] on the dates specified herein for receipt of such payment, then [the taxpayer] may, at it's sole discretion, halt work until monies due are paid.

In both instances the agreement provides that the taxpayer will receive payments as the work is completed. The taxpayer contends that the cash amounts received do not "proceed or accrue to the taxpayer" until the contract work is completed and that only then does the taxpayer "become entitled to compensation", within the purview of the rule. The taxpayer argues that the terms "value proceeding or accruing" and "compensation", as used in Rule 197, must refer to "earned income". As to the periodic progress payments the taxpayer asserts that there is no practical way to determine how much of such actual payments have been "earned", or are amounts to which the taxpayer, "becomes entitled to as compensation", under Rule 197(4)(b), until the contract is completed.

It is apparent from the terms of the contract that as the work progressed and was completed the taxpayer was entitled to payment. No evidence has been presented that the taxpayer acted as a guardian or trustee of any funds advanced either before or during the construction. Nothing has been presented to support that these funds were not commingled with other operating funds and were not treated as anything but operating income. There is

no evidence that a trust or fiduciary relationship was created as a result of the taxpayer's relationship.
Under agreements written or oral, a party may be entitled to consideration or compensation upon the mere making of a promise to perform. The fact that his right to retain funds advanced may be qualified by his ultimate performance does not transform the compensation received into security or trust funds. Black's Law Dictionary 283 (6th ed. 1990), defines compensation as "Remuneration for services rendered, whether in salary, fees, or commissions".

We are convinced that all amounts paid to the taxpayer designated as periodic progress payments constitute consideration to the taxpayer, actually received. Therefore under the rule, these amounts are compensation to which the taxpayer was entitled at the time of payment, which can certainly be no later than at the time they are actually received by the contractor. Thus, we find that the Department was correct in treating progress payments as taxable at the time they were received by the taxpayer. Accordingly, the taxpayer's petition is denied as it relates to the issue of recognition of income.

The taxpayer also requests the audit report be corrected to reflect a recently discovered bookkeeping error. Following the audit, the taxpayer discovered that its business records recorded gross receipts from construction income that included the retail sales tax collected. The Department's use of this figure reconciling income resulted in the taxpayer paying retail sales tax on retail sales tax already collected.

This appears to be strictly a factual matter and is being referred to the Audit Division for verification and the making of such corrections in the audit as are found to be in order.

DECISION:

The taxpayer's petition is denied in part and granted in part. The taxpayer's petition is denied as it relates to timing of recognition of income. We find the Department was correct in taxing the progress payments when they were received. The taxpayer's petition is granted as it relates to an adjustment for tax paid on income that included retail sales tax collected. This issue is remanded to the Audit Division for verification and adjustment.

DATED this 28th day of April, 1994.