Cite as 5 WTD 53 (1988)

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

In the Matter of the Petition For Correction of Assessment of)	D E T E R M I N A T I O N
)	No. 88-22
. . .)	Registration No. . . .

[1] **RULE 197 AND RULE 199:** ACCRUAL BASIS TAXPAYER -- WHEN TAX LIABILITY ARISES -- FINANCIAL STATEMENTS. A taxpayer that makes year end adjustments to financial statements is not otherwise required to report the income subject to the adjustment in the previous year. Taxpayer bills customers in January for services rendered in December; taxpayer accrues the income in January, not December, for tax reporting purposes.

[2] **RULE 251:** SEWER SERVICES -- ALLOCATION -- PUBLIC UTILITY TAX -- B&O TAX. A taxpayer may allocate between PUT and B&O tax under the formula prescribed in Rule 251. Engineer's report setting forth allocation formula in conformance with the rule requirements found acceptable.

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 additional tax relating to two schedules in the audit report. In the first, the taxpayer disagrees with the auditor's method of determining gross receipts. In the second situation, the taxpayer seeks a reclassification of certain income for providing sewer services.

FACTS AND ISSUES:

Mastrodonato, A.L.J. -- The taxpayer is a local sewer district in . . . County, Washington. The Department of Revenue examined the taxpayer's business records for the period from January 1, 1983,

through March 31, 1987. As a result of this audit, Tax Assessment No. . . . was issued on August 13, 1987, stating a total tax and interest deficiency in the amount of $ . . . . The taxpayer made a partial payment of $ . . . on September 30, 1987. The balance of the assessment remains unpaid.

The taxpayer protests two areas of assessment in the audit report. First, the taxpayer disagrees with the gross receipts subject to tax as determined by the auditor. The auditor took income figures from the taxpayer's annual financial statements and assessed tax on those amounts. These figures differed from the method by which the taxpayer normally accrues income.

The taxpayer points out that under RCW 82.04.090, gross receipts are to be reported based on the accounting method regularly employed by the taxpayer. The taxpayer's normal method of accounting is to record revenue at the time utility bills are rendered. This is done on a two month cycle such that at year end, part of the district has received services in December that are not billed until January of the following year. In preparing the financial statements of the district, the taxpayer's CPA accrued this unbilled revenue and reported it as income for December of the previous year on the taxpayer's financial statements. However, the taxpayer contends that this income was not accrued in the month of December on its regular books of account.

The taxpayer recognizes that Method 3 of WAC 458-20-199 (Rule 199) requires some taxpayers to report accrued receivables at year end. However, the taxpayer points out that the rule specifically excludes taxpayers who are engaged in service industries and which are not liable for the collection of retail sales tax. This exclusion thus places the taxpayer outside the scope of Method 3. Furthermore, since the adjustment detailed above was made after year end by an outside accountant, the taxpayer argues that the information was not even available at the time the excise tax reports were prepared and filed in the month of January.

Consequently, the taxpayer requests that it be allowed to report its gross receipts based upon its regular method of accounting, rather than based upon year end financial reports and statements.

The second area of disagreement involves the proper classification of income. In the audit report, all of the taxpayer's gross receipts received in connection with sewer services were taxed at the public utility tax rate. However, the taxpayer contends that those gross receipts were derived from both the collection of sewage, which is taxable at the public utility rate (beginning on July 1, 1985), and the treatment of sewage, which is taxable under the "service" business and occupation (B&O) tax rate.

In support of this portion of the protest, the taxpayer has presented several documents: (1) a written formula used by other

sewer districts, and accepted by the Department of Revenue, which allocates gross receipts between these two types of sewer services, (2) application of the formula to the taxpayer's facilities, and (3) an engineering report which supports the allocations used.

Therefore, the taxpayer requests that this formula be approved for use beginning July 1, 1985, and that the taxpayer's tax liability be adjusted accordingly.

DISCUSSION:

[1] Throughout the audit period, the taxpayer reported its gross income under either the business and occupation tax or public utility tax classifications. The measure of tax is the "gross income of the business" (RCW 82.04.280) or "gross income" (RCW 82.16.010(12)) for the B&O tax or public utility tax, respectively. In each case, the term means the "value proceeding or accruing" by reason of the transactions of the business engaged in, or from the performance of the particular service business involved, as the case may be. The term "value proceeding or accruing," for purposes of both tax classifications, 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. (Emphasis supplied.)

Thus, the law mandates that an accrual basis taxpayer realize taxable income when the income is accrued and not when the taxpayer actually receives payment or even when financial statements are prepared.

The statutes mentioned above are implemented by two 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 TWO, ACCRUAL BASIS. Persons operating their business on the accrual basis must report under the business and occupation tax [or public utility tax] and the retail sales tax for each tax reporting period the gross proceeds from all cash sales made during such period, together with the total amount of charge sales during such period.
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> 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. If this method is adopted, an adjustment shall be made at the end of the calendar year to add to cash received the amount of accounts receivable at the end of the year (not previously reported) to be reported along with cash receipts. A statement should accompany the return indicating the amount of accounts receivable so added. A deduction maybe taken on subsequent returns filed in periods when cash is received upon accounts receivable so reported. . . .
>
> 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. (Emphasis and bracketed inclusion supplied.)

WAC 458-20-197 (Rule 197) deals with when tax liability arises. It states in part:

> 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.
>
> . . .
>
> ACCRUAL BASIS. When returns are made upon the accrual basis, value proceeds or accrues to a taxpayer as of the time the taxpayer actually receives, becomes legally entitled to receive or in accord with the system of accounting regularly employed enters as a charge against the purchaser, customer, or client the amount of the consideration agreed upon, whether payable immediately or at a definitely determined future time.
>
> As to amounts actually received, however, such amounts do not constitute value proceeding to the taxpayer in the period in which received if the gross proceeds of sales or gross income of the pursuant to the foregoing, constitute value accruing to the taxpayer during another period. It is immaterial whether the act or service out of which the consideration proceeds or accrues is performed or rendered, in whole or in part, during a period other than the one for which return is made, the controlling factor in this case being the time as of which the taxpayer received, or takes credit for, the agreed consideration. (Emphasis supplied.)

See 2 WTD 411 (1987). Thus, in our opinion, the taxpayer is an accrual basis taxpayer that should be utilizing Method 2 of Rule 199. Furthermore, the above rules clearly require, in conformance

with the law, that a taxpayer that keeps its accounts on the accrual basis, must report its tax liability to the state on that same basis. Under Rule 197, an accrual basis taxpayer may report its income in accordance with the system of accounting that it regularly employs. One method allows the income to accrue when the taxpayer enters as a charge against the customer for the amount of consideration due.

In this case, the taxpayer accrues revenue at the time the utility bills are rendered. Because the taxpayer bills its customers on a two month cycle, some customers are not billed for services received in the month of December, until the January billings are rendered. Thus, for purposes of Rules 197 and 199, the taxpayer does not accrue this income, nor does the tax liability arise, until the month of January. Consequently, the taxpayer was not required to report this income until it billed its customers in the month of January, even though the services were actually rendered in the month of December.

The fact that the services were performed in the month of December and the taxpayer recaptured this income for purposes of preparing its year end financial statements, is not dispositive. Under Rule 197, the system of accounting employed by the taxpayer resulted in an accrual of income when the customer was billed for the sewer services. At year end, some customers were billed in January for services rendered in December. The income thus accrued when the customer was charged for the service; this occurred in the month of January. Furthermore, Rule 197 also states that

> . . . it is immaterial whether the . . . service . . . is performed or rendered, in whole or in part, during a period other than the one which return is made, . . .

because the controlling factor is when

> . . . the taxpayer received, or takes credit for the agreed consideration.

Again, all of these factors occurred in January, notwithstanding the year end adjustments made for purposes of preparing the taxpayer's financial statements.

Therefore, we hold that under the taxpayer's regular method of accounting, the income in question was not accrued until customers were billed in the month of January. The audit will be adjusted with respect to this issue.

[2] Second, the taxpayer has protested the assessment of public utility tax on all of its income received since July 1, 1985. The taxpayer believes that a portion of its income is related to the treatment or transmission of sewage, and should be taxed under the "service" B&O tax classification.

WAC 458-20-251 (Rule 251) is the Department's administrative regulation which outlines the state tax requirements of businesses performing sewerage collection and other ancillary services. Although there was some confusion over the proper tax classifications following the enactment of Chapter 471, Laws of 1985, Rule 251 now expressly provides that effective July 1, 1985

> . . . only the portion of gross receipts from customer billings attributable to the "collection" portion of services rendered.
> . . .

are taxed under the public utility tax classification. WAC 458-20-251(2). Thus, activities that do not involve the "collection" of sewerage are not taxed under the public utility tax.

WAC 458-20-251(3)(a) provides a definition of "sewerage collection business." It provides as follows:

> "Sewerage collection business" means the activity of receiving sewage deposited into and carried off by a system of sewers, drains, and pipes to a common point, or points, for disposal or for transfer to treatment for disposal, but does not include such transfer, treatment, or disposal of sewage. (Emphasis supplied.)

Rule 251 also defines the term "gross receipts" for purposes of the taxation of sewerage collection businesses. It states as follows:

> "Gross receipts" of the sewerage collection business means only that portion of income from customer billings which is allocable to the collection of sewage by a sewerage collection business as defined herein.
>
> (i) "Gross receipts," as defined here, is the public utility tax measure. It does not include any charges of any kind attributable to sewerage services other than collection.
>
> (ii) The term does not include late charges or penalties which may be imposed for non-timely payment by customers. (Emphasis supplied.)

WAC 458-20-251(3)(c). The rule specifically states that a business may be taxable under both the public utility tax and B&O tax classifications. WAC 458-20-251(4) states:

> Persons engaged in the sewerage collection business may also be engaged in related business activities involving the interception, transfer, storage, treatment, and/or disposal of sewage, or any of these activities. If so,

such persons are engaged in both public utility taxable activities (sewerage collection) and business and occupation taxable activities (other sewer services). See RCW 82.16.060 and 82.04.310.

With respect to the collection portion of the business, Rule 251 provides a comprehensive discussion of the proper calculation of tax liability. It states:

(5) Public utility tax. Persons engaged in the sewerage collection business, as defined herein, are subject to the public utility tax under the classification, sewer collection, measured by "gross receipts" of the collection business as explicitly defined herein, at the currently prescribed rate. (See RCW 82.16.020(1)(a).)

(6) In order to determine the "gross receipts" of the collection business there are two alternative methods.

(a) If customer billings are itemized to show the actual charge for sewage "collection," that amount is the "gross receipts" tax measure: Provided, That such amount shall not be less than the actual cost of providing the collection service.

(b) If collection services are provided jointly with other, related sewer services provided by the sewerage collection business or any other person, and the actual charge for sewerage "collection" is not itemized on customer billings, a simple cost-of-doing-business formula must be used to derive the "gross receipts," public utility tax measure.

(i) The totality of all business costs incurred in rendering all sewer services, including collection, is to be divided into the costs of providing sewerage collection services. The resulting percentage is to be multiplied by gross income from customer billings (all sewerage regulated charges). The result is the "gross receipts" public utility tax measure from engaging in the sewerage collection business.

(ii) The formula looks like this:

Sewage collection costs (Annualized)		Public Utility
_____ Total sewer service costs (Annualized)	=____% x gross billings =	Tax Measure

(iii) All costs of operation of the sewer services business must be included in the denominator, including

> but not limited to capitalized equipment, labor, direct and indirect overhead, and administration.
>
> (iv) The standard cost accounting records of the sewerage collection business will be used for this purpose.
>
> (v) For the purpose of annualizing its costs, the sewerage collection business may use the previous calendar year costs or its budget allocations for the current tax year. In either case, however, it must make an end of year adjustment to its reporting based upon actual costs incurred during the current year.

Finally, the rule addresses the taxability of other sewerage services by stating at WAC 458-20-251(7) as follows:

> Business and occupation tax. Persons engaged in providing other sewer services, in addition to or separate from the "sewerage collection business" as defined herein, are subject to the business and occupation tax under the classification, service and other business activities. The measure of this tax is the gross income derived from such other services. It does not include any amount reported for public utility tax under the sewer collection classification.

To sum up, only the collection portion of sewerage services is subject to public utility tax. The remainder of the charge is subject to "service" B&O tax.

If a taxpayer does not separately itemize on customer billings the specific charge for collection services (see WAC 458-20-251(6)(a)), then the taxpayer must use a cost-of-doing-business formula to ascertain the proper allocation of receipts between those taxable under the public utility tax and those taxable under the B&O tax. See WAC 458-20-251(6)(b). (A complete recitation of the formula is set forth above.)

In this case, the taxpayer disputes the auditor's findings that all of its income relates to the collection of sewerage. Instead, the taxpayer believes that a portion of its income relates to the treatment of sewerage. The income from this latter activity, the taxpayer contends, is subject to "service" B&O tax.

To substantiate its claim, the taxpayer has presented an engineering report which establishes an allocation formula and applies that formula to the year 1985. The report shows "collection" as 23.23 percent of total operating costs. The remainder (76.77 percent) is allocated to transfer. (In 1986, the percentage allocation changed and the taxpayer has presented a schedule for that year also.)

In our opinion, the taxpayer has met its burden of establishing entitlement to an allocation of tax liability between public utility tax and B&O tax based upon collection and other sewer services, respectively. Consequently, the audit report will be adjusted in accordance with the engineering reports and schedules submitted by the taxpayer.

DECISION AND DISPOSITION:

The taxpayer's petition is sustained. The audit report and tax assessment will be corrected in accordance with the guidelines contained herein. Following those audit adjustments, the Department will issue an amended assessment and any tax and interest remaining will be due on the date shown thereon.

DATED this 12th day of February 1988.