

Cite as 5 WTD 129 (1988)

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

In the Matter of the Petition)	<u>D</u> <u>E</u> <u>T</u> <u>E</u> <u>R</u> <u>M</u> <u>I</u> <u>N</u> <u>A</u> <u>T</u> <u>I</u> <u>O</u>
<u>N</u>	
For Refund of)	
)	No. 88-141
)	
. . .)	Registration No. . . .
)	
)	

[1] **RULE 197 AND RULE 199:** WHEN TAX LIABILITY ARISES -- ACCRUAL BASIS TAXPAYER -- DISCOUNT. A taxpayer who keeps accounting records on the accrual basis must report B&O tax as accounts receivable are accrued. A subsequent sale, at a discount, of the accounts receivable, cannot adjust or modify the original measure of the tax.

[2] **RULE 196:** BAD DEBTS -- DISCOUNT. A taxpayer cannot declare the discount associated with the sale of accounts receivable as a credit loss or bad debt.

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 seeks a refund of Service business and occupation (B&O) tax paid in connection with the sale of accounts receivable at a discount on the ground that the discount was entitled to be treated as a bad debt deduction.

FACTS AND ISSUES:

Mastrodonato, A.L.J. -- The taxpayer operates an . . . training school which specializes in training students for employment with various . . . agents, and other . . . industry employers. The Department of Revenue performed an audit of

the taxpayer's business records for the period from April 1, 1983 through March 31, 1987. As a result of this audit, Tax Assessment No. . . . in the amount of \$. . . was issued on October 6, 1987. The taxpayer paid the assessment in full on October 16, 1987, and, by letter dated October 19, 1987, requests a partial refund. This Determination responds to the taxpayer's petition for refund.

The amount of the alleged tax overpayment totals \$. . . , plus applicable refund interest. The item in question is a claim for a bad debt deduction. The taxpayer sells its accounts receivable to its affiliated or "sister" corporation, [A]. The taxpayer sells its receivables to [A] shortly after sales (notes) are made. The amount of the sale to [A] includes a discount.

The taxpayer argues that this discount should constitute an allowable B&O tax deduction as a bad debt. The discount constitutes the difference between the taxpayer's accounts receivable balance and the amount it receives when the account is sold to [A].

The taxpayer believes that if a bad debt deduction is not allowed, double taxation results. This is because the taxpayer pays Service B&O tax on its total revenues, even though no payments are received. The Department does not allow a bad debt deduction to be taken for account balances (receivables) sold or transferred to [A]. [A], in turn, pays Service B&O tax on all payments collected and does not take a bad debt deduction on uncollectible accounts because no B&O tax is paid by [A] until an amount is actually paid. The taxpayer argues that this application is inequitable.

DISCUSSION:

The issue presented is whether the taxpayer is entitled to take a bad debt deduction on the amount of discount realized when accounts receivable are sold to [A]. After thoroughly reviewing this matter, we conclude that the bad debt deduction is not applicable.

[1] At the outset we agree that the taxpayer's income is subject to the B&O tax under the Service classification at the time the notes are created. RCW 82.04.290. The measure of the "service" tax is the "gross income of the business" which is defined by RCW 82.04.080 to mean

. . . the value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, compensation for the rendition of services, gains realized from trading in stocks, bonds, or other evidences of indebtedness, interest, discount, rents, royalties, fees, commissions, dividends, and other emoluments however designated, all without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses. (Emphasis supplied.)

Thus, the term "gross income of the business," includes the concept of discount in two significant places. First, gross income includes discount as part of the "value proceeding or accruing." Second, the term does not allow for a deduction for any discount paid or accrued. The term "value proceeding or accruing" is defined by statute (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.)

Taken together, these statutory definitions require that the Service B&O tax be paid on the total consideration paid or accrued, without any deduction for any discount paid or accrued. Also, RCW 82.04.080 essentially says that any discount realized by a taxpayer is an expense for which the B&O tax provides no deduction.

In this case, and under the definitions of "gross income of the business" and "value proceeding or accruing," the taxpayer is liable for B&O tax on the total amount of its income, as no deduction is permitted for the discount realized when the contracts are sold to [A]. Since the taxpayer's accounting is on an accrual basis, the total amount of income is realized when the taxpayer accrues the income, and not when it actually receives a (discounted) payment from a financial entity ([A]) to whom the contract is sold.

The two 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:

Persons operating their business on the accrual basis must report under the business and occupation 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.

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.

. . . 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.)

These rules clearly require, in conformance with the law, that a taxpayer who keeps its accounts on the accrual basis report its tax liability to the state on that same basis.

[2] In addition to the above, the law does allow taxpayers to deduct credit losses or bad debts from the measure of their tax liability. RCW 82.04.4282 states:

In computing tax there may be deducted from the measure of tax the amount of credit losses actually

sustained by taxpayers whose regular books of account are kept upon an accrual basis.

This section of the tax law is also implemented by an administrative rule. WAC 458-20-196 (Rule 196) states in pertinent part:

In computing business and occupation tax there may be deducted by taxpayers whose regular books of accounts are kept upon an accrual basis, the amount of business credit losses actually sustained, providing that such deduction will be allowed only with respect to transactions upon which a tax has been previously paid and providing that the amount thereof has not been otherwise deducted and that credits have not been issued with respect thereto.

Bad debt deductions must be taken by the taxpayer during the tax reporting period during which such bad debts were actually charged off on the taxpayer's books of account. (Emphasis supplied.)

It is clear from the above that a discount is not a credit loss or a bad debt, since it is not a debt that is charged off of a taxpayer's books of account. According to Black's Law Dictionary, 4th Edition Revised (1972), discount means "the taking of interest in advance." Thus, in the commercial world, a discount is a drawback or deduction made upon an advance or loan of money, upon negotiable paper or other evidence of debt, payable at a future date, which are transferred or sold. In our opinion, the difference between discount and a bad debt is that, with respect to the former, the transferee (here, the taxpayer) voluntarily receives less consideration in advance for the immediate sale of a note, whereas in the latter case, the realization of a credit loss or bad debt is the result of nonpayment of an accrued receivable by a customer, which event is wholly outside the control of the seller or creditor.

In summary, the taxpayer cannot claim a bad debt deduction when it sells its accounts receivable to an affiliated corporation at a discount. The difference between the amount of the original accounts receivable and the amount realized in the subsequent sale of the accounts receivable to [A] is not within the ambit of the bad debt deduction, as contemplated by RCW 82.04.4282 and Rule 196. Furthermore, the fact that the taxpayer is required to pay B&O tax on its gross income before it sells the accounts receivable at a discount to [A], and the

latter is also required to pay B&O tax on its income from actually collecting the accounts receivable, is not unlawful double taxation, as the taxpayer argues. Instead, this is the intended result of the B&O tax scheme, where the tax is due and payable on all business transactions. See RCW 82.04.140, RCW 82.04.150, and RCW 82.04.220.

DECISION AND DISPOSITION:

The taxpayer's petition for refund is therefore denied.

DATED this 26th day of February 1988.