

Cite as 9 WTD 292-9

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</u>
<u>N</u>		
For Correction of Assessment)	
of)	No. 90-216
)	
[Company A])	Registration No. . . .
)	. . . /Audit No. . . .
)	
)	
)	
)	
[Company B])	Registration No. . . .
)	. . . /Audit No. . . .
)	
[Company C])	Registration No. . . .
)	. . . /Audit No. . . .
)	

[1] **RULE 111 & 207:** B&O TAX -- ATTORNEYS -- ADVANCE AND REIMBURSEMENTS -- OVERHEAD CHARGES. Reimbursed expenses attributable to photocopying charges, long distance telephone charges, set-up fees, mileage, and traveling costs constitute the recovery of "overhead charges" and may not be excluded from gross income. . . . See also Christensen, O'Connor, Garrison & Havelka v. Department of Revenue, 97 Wn.2d 764, 649 P.2d 839 (1982).

[2] **MISC:** RETAIL SALES TAX -- DOCUMENTATION OF TAX PAID --SUMMARY BY PURCHASING AGENT. A request for reimbursement by the purchasing agent of a taxpayer that separately itemizes the amount of retail sales tax paid to vendors is insufficient documentation to substantiate that retail sales tax was in fact paid. An invoice, bill of sale, or other instrument of sale issued by the vendor that clearly and

separately itemizes the amount of retail sales tax collected and remitted is required. . . .

- [3] **RCW 82.32.070:** TEST PERIODS -- LOST RECORDS -- UNREPRESENTATIVE PERIOD. RCW 82.32.070 requires the taxpayer to keep and preserve suitable records so that its tax liability may be correctly determined. Where the taxpayer failed to fulfill that duty, thus necessitating a projection based upon the records available, the taxpayer's argument that the test period was not representative was rejected.

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 HEARING: May 4, 1990

NATURE OF ACTION:

Three taxpayers protest additional taxes and interest assessed in their audit reports.

FACTS AND ISSUES:

Okimoto, A.L.J. -- [A]; [B]; and [C]; are successive entities that were or are engaged in the practice of law in the . . . , Washington area. They will be referred to as "taxpayer" collectively, or by their initials whenever appropriate.

A Department of Revenue (Department) auditor examined the books and records of each of the above taxpayers for their respective periods of operation. As a result of the audits, the above assessments were issued for additional taxes and interest. The taxpayers have protested these assessments and the balances remain due.

TAXPAYER'S EXCEPTIONS:

[A]

In the audit examination, the auditor tested eleven months of [A]'s reported income during the year . . . and determined that [A] was incorrectly excluding from gross receipts amounts received from its clients for reimbursed expenses. The

auditor disallowed exclusions on the following reimbursed expenses: copying charges, long distance telephone calls, file set-up fee, mileage, postage, rent, phone service, coffee service, photo copies, and other miscellaneous charges. Based on this test period, the auditor made two projections. The first projection utilizes reported income as a base and estimates the total amount of reimbursed expenses excluded from gross income throughout the audit period. The second projection uses this estimated amount of reimbursed expenses as a base, and then applies the percentage of taxable expenses during the test period to arrive at the total amount of taxable reimbursed expenses for the entire audit period.

The taxpayer protests additional Service tax assessed on amounts received from its client for reimbursed expenses attributable to copying charges, long distance telephone charges, set-up fees, mileage, and traveling costs.

Taxpayer argues that WAC 458-20-207 (Rule 207) creates three distinct rules for determining which reimbursed expenses are excludable from gross income for purposes of computing B&O taxes. These are:

1. A law firm can exclude items which are advanced or expended in litigation and for which the client is liable under RPC 1.8.
2. A law firm can exclude non-litigation expenses when the attorney has no obligation to pay "other than as agent for the client or equivalent commitment for their payment."
3. General overhead items even if allocable to clients or items for which the law firm assumes personal responsibility are not excludable.

The taxpayer cites WAC 458-20-111(Rule 111) which states that a taxpayer may exclude "from the measure of tax amounts representing money or credit received by a taxpayer as reimbursement of an advance in accordance with the regular and usual custom of his business or profession." The taxpayer next cites RPC 1.8(e) which allows an attorney to advance "expenses of litigation" so long as the client is ultimately liable for repayment. By combining Rule 111 and RPC 1.8(e) the taxpayer argues that because it is the regular and usual custom of an attorney to advance expenses of litigation, reimbursements for all such expenses are excludable from an attorney's gross income.

Next, the taxpayer argues that even amounts received for expenses relating to non-litigation matters are excludable if they are not general overhead-type expenses. The taxpayer argues that if the expense occurred "but for" the needs of the client in litigation or non-litigation matters, then the expense is not a general overhead-type expense and is excludable as an advance and reimbursement.

Applying the above reasoning, the taxpayer believes that the following reimbursed expenses should be excludable from gross income.

1. Amounts that the attorney charges to the client for copying court documents filed on the client's behalf.
2. Amounts charged for long distance phone calls made on the client's behalf.
3. Amounts charged to the client for setting up a "client file."
4. Amounts charged to the client for mileage traveled on behalf of the client.
5. Amounts charged for other miscellaneous expenses such as air fare, parking, and film developing.

In addition to protesting the tax, [A] also protests the test period used to estimate the amount of taxable reimbursed expenses. [A] believes that the test period is not representative because the number of employees increased throughout the audit period, and because the purchase of a copy machine midway through the audit period substantially increased the amount of reimbursed copying charges. In addition, it states that a file set up fee was not consistently implemented until

The auditor also assessed use and/or deferred sales tax on computer equipment purchased through [Mr. R]. At the hearing, [A] presented a summary prepared by [Mr. R] which separately itemized the computer equipment purchased, the services purchased, and the amount of sales tax paid. [A] argues that this summary indicates that [Mr. R] collected the retail sales tax from [A], and therefore [Mr. R] is solely responsible for remitting the tax to the state. In addition, [A] presented an affidavit signed by [Mr. R] stating that [Mr. R] acted solely

as a purchasing agent for [A] in acquiring the computer equipment and that [Mr. R] paid retail sales tax directly to the vendors on all purchases.

[B],

[B] also protests Service tax assessed on amounts received from its client for reimbursed expenses attributable to copying charges, long distance telephone charges, set-up fees, mileage, and traveling costs.

[B] also protests the application of an error percentage derived from testing the tax reporting procedures of a separate legal entity being used to compute its own tax liability. [B] argues that the test period is unrepresentative.

[C],

[C] also protests Service tax assessed on amounts received from its client for reimbursed expenses attributable to copying charges, long distance telephone charges, set-up fees, mileage, and traveling costs.

[C] also protests the application of an error percentage derived from testing the tax reporting procedures of a separate legal entity being used to compute its own tax liability. Although [C] concedes that it can not presently locate records upon which to compute a new error percentage, it nevertheless argues that the test period is unrepresentative.

ISSUES:

1. May an attorney exclude from gross income amounts recovered from clients for photocopying charges, long distance telephone charges, set-up fees, mileage, and traveling costs?
2. Does a request for reimbursement by a purchasing agent that separately itemizes the amount of retail sales tax paid to vendors constitute sufficient documentation to substantiate that retail sales tax was in fact paid?
3. Where a portion of taxpayer's records are lost, or otherwise unavailable, may a taxpayer object to the test period as being non-representative?

DISCUSSION:

[B]

[1] We believe the taxpayer significantly misconstrues the meaning of Rules 111 and 207. Although it is true that Rule 111 allows a taxpayer to exclude from gross income reimbursements for advances made in accordance with the usual custom of his profession, Rule 111 also limits that exclusion to:

... cases wherein the taxpayer, as an incident to the business, undertakes, on behalf of the customer, guest or client, the payment of money, either upon an obligation owing by the customer, guest or client to a third person, or in procuring a service for the customer, guest or client which the taxpayer does not or cannot render and for which no liability attaches to the taxpayer. It does not apply to cases where the customer, guest or client makes advances to the taxpayer upon services to be rendered by the taxpayer or upon goods to be purchased by the taxpayer in carrying on the business in which the taxpayer engages.

The Washington State Supreme Court addressed this very issue in the case of Christensen, O'Connor, Garrison & Havelka v. Department of Revenue, 97 Wn.2d 764, 649 P.2d 839 (1982). In Christensen, the Court outlined a three pronged test to determine whether a Rule 111 exemption from gross income was appropriate:

I. Repayments are customary reimbursements for advances made to procure a service for the client.

...

II. Repayments involve services that the taxpayer did not or could not render.

...

III. Taxpayer is not liable for the initial payments.

... An attorney is not liable for charges incurred by the attorney on behalf of his client unless the attorney assumes such liability.

Christensen, at 769-70.

Rule 207 codifies this ruling and provides the following guidelines:

General overhead costs are includable in the tax measure even though an attorney may allocate those costs among particular clients. Likewise, any other costs for which the attorney assumes personal liability other than as stated above [as agent] are includable in the tax measure.

Thus, amounts received to compensate for the following costs are fully subject to tax, even though they may be separately stated on the billings or expressly denominated as costs of the client:

- A. Photocopy or other reproduction charges.
- B. Long distance telephone tolls.
- C. Secretarial expenses.
- D. Travel, meals and lodging.
- E. Third party service providers (for example, accountants, appraisers, architects, artists, draftsmen, economists, engineers, investigators, physicians, etc.) to whom the attorney assumes personal liability for payment. (Emphasis ours.)

Applying the above three pronged test and Rule 207 to the taxpayer's exceptions we find as follows.

1. Photo-copying charges: Because the taxpayer himself performs the copying services, these charges fail to meet the last two requirements of the above test and therefore are not exempt. In addition, they are specifically listed as taxable in Rule 207.
2. Long distance phone calls made on the client's behalf: Because the taxpayer himself assumes personal liability for the calls, the charges are not exempt. We note that they are also specifically listed as being taxable in Rule 207.
3. Charges made to the client for setting up a "client file": Because the taxpayer himself performs the file set up services, they fail to meet the last two requirements.
4. Charges made to the client for mileage traveled on behalf of the client: Again these reimbursements fail to meet the last two requirements and are specifically listed as being taxable in Rule 207.
5. Other miscellaneous expenses such as air fare, parking, and film developing: Because liability for these charges are normally personally assumed by the taxpayer they fail to satisfy the third test.

Accordingly, we must deny [A]'s petition on this issue.

Concerning [A]'s objection to the test period, we note that the auditor based her projection on income, which would necessarily reflect any variance in the number of employees during the periods in question. Presumably, as the number of employees increased, so would the income. Nevertheless, if [A] believes that the test period is not representative, we believe that he is certainly entitled to expand that test period. Accordingly, [A] may choose an additional test period, and compute the total amount of unreported and disallowed reimbursed expenses for that period and present the results to the auditor. Upon verification by the auditor, this additional test period shall be combined with the original period.

[2] We have carefully examined the summary prepared by [Mr. R.]. At first glance, one could conclude that [Mr. R] separately stated the amount of retail sales tax and that he collected the tax from [A] in the capacity as a vendor of the computer equipment. Upon closer examination, however, it becomes clear that the stated tax rate (8%) does not tie into any of the listed subtotals. This fact, together with [Mr. R]'s signed affidavit stating that he acted solely as a purchasing agent, and paid retail sales tax directly to the vendors, makes it evident that the summary was only [Mr. R]'s request for reimbursement on expenditures made on behalf of [A]. Therefore, because we conclude that [Mr. R] was acting only as a purchasing agent of [A], [Mr. R]'s affidavit that he paid retail sales tax to the vendors of the computer equipment is simply insufficient documentation to substantiate that retail sales tax was in fact paid. An invoice, bill of sale, or other instrument of sale issued by the vendor that clearly and separately itemizes the amount of retail sales tax collected and remitted to the State is required. Accordingly, we must deny [A]'s petition on this issue.

[B],

Unless a taxpayer agrees otherwise, we believe that the tax reporting procedures of each legal entity should be tested separately. Any additional tax liability assessed should be based upon its own books and records. Accordingly, the auditor is instructed to examine a mutually agreeable test period of unreported reimbursements for this entity and make a new projection.

[C],

[3] RCW 82.32.070 states:

Every person liable for any fee or tax imposed by chapters 82.04 through 82.27 RCW shall keep and preserve, for a period of five years, suitable records as may be necessary to determine the amount of any tax for which he may be liable,... Any person who fails to comply with the requirements of this section shall be forever barred from questioning, in any court action or proceedings, the correctness of any assessment of taxes made by the department of revenue based upon any period for which such books, records, and invoices have not been so kept and preserved. (Emphasis ours.)

The above statute requires the taxpayer to keep and preserve suitable records so that its tax liability may be correctly determined. Where the taxpayer has failed to fulfill that duty, thus necessitating a projection based upon the records now available, we will not favorably entertain an argument that the test period is unrepresentative. Should the taxpayer subsequently, locate its records, it may present them to the audit section for the appropriate examination. Accordingly, we must deny the taxpayer's petition on this issue.

DECISION AND DISPOSITION:

The taxpayer's petition is granted in part and denied in part.

DATED this 25th day of May of 1990.