Cite as Det. No. 91-096, 11 WTD 123 (1991)

THIS DETERMINATION HAS BEEN OVERRULED OR MODIFIED IN WHOLE OR PART BY DET. NO. 93-269ER, 14 WTD 153 (1995).

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

In the Matter of the Petition For Ruling Of	)	D E T E R M I N A T I O N
	)	No. 91-096
. . .	)	Unregistered Request for Ruling

[1] RULE 109: B&O TAX - DEDUCTION - THIRD PARTY LOANS -INTEREST - TAXPAYER ACTING AS CONDUIT. When a taxpayer acts as a conduit in procuring a loan from a third party lending source for the benefit of a related company on a straight pass-through (conduit) basis, and all interest charged and received by the taxpayer from the related company is repaid to the taxpayer's third party lender, tax is not due on such interest income. Howard S. Wright cited. Accord: Det. No. 88-246, 6 WTD 89 (1988), Det. No. 89-88, 7 WTD 185 (1989).

[2] RULE 109: B&O TAX - EXEMPTION - CASH MANAGEMENT -NO INTEREST CHARGED. Money management activity by a taxpayer without any nonfinancial business activity may be exempt only if interest is not charged. 4 WTD 341 (1987) cited. Accord: Det. No. 86-309A, 4 WTD 341 (1987).

[3] RULE 109: B&O TAX - EXEMPTION - CASH MANAGEMENT -LOAN FROM TAXPAYER. An otherwise exempt cash management activity will not be rendered taxable merely because the managing taxpayer borrows money in its own name in order to maintain a minimum balance in the cash management account, and then repays the loan from the money management account when funds over the minimum balance are available.

[4] RULE 109: B&O TAX - EXEMPTION - CASH MANAGEMENT ACCOUNT - INVESTMENT OF SURPLUS FUNDS. When a taxpayer who administers an otherwise exempt cash management system for its affiliates makes short-term (overnight) investments of surplus cash management funds, it will be exempt from B&O tax on investment interest so earned under the following circumstances:

(1) the taxpayer is not a "security, investment, or financial business" under RCW 82.04.4281, in that it

(a) performs financial functions only for its corporate affiliates with no object of gain, and

(b) is not in competition with other "security, investment, or financial businesses,"

(2) the taxpayer has no beneficial interest in the interest earned on the funds, and interest is deposited directly into the money management fund,

(3) the affiliates for whose benefit the fund is managed are not "security, investment, or financial business[es]" and

(4) interest derived on the fund's behalf is incidental and de minimis when compared with the participating affiliates' gross income.

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: . . .

NATURE OF ACTION:

Petition concerning the taxability of a taxpayer who procures loans for its affiliates and administers a cash management fund.

FACTS:

Bauer, A.L.J. -- The taxpayer is a . . . corporation affiliated with a large . . . corporation with worldwide sales in excess of $6 billion. It is considering establishing its U.S. headquarters in [Washington]. The taxpayer does not have any employees or a presence in Washington State.

The taxpayer requests a ruling that interest income earned by it from the following sources would be exempt from Washington State B&O tax: (1) intercompany loans, (2) cash management, and (3) incidental interest income, as described below:

TAXPAYER ARGUMENTS:

(1) Intercompany Loans

[The taxpayer], acting as a finance conduit, will borrow from foreign affiliates and domestic third parties and loan the proceeds to its affiliates which will use the proceeds for operating purposes, payment of third-party debt, and to fund loans or capital contributions to other affiliates. This process could continue through two or more 100%-owned affiliates in the corporate chain. Ultimately, some or all of the proceeds would be paid back to [the taxpayer] for payment directly to the lenders. The interest rate at which [the taxpayer] borrows the funds will be the same as the interest rate it charges to domestic affiliates. The possible combinations of loan and capital transactions are exhaustive; however, all transactions will be similar to the following scenario:

a. Intercompany loans will be separate and distinct from cash management transactions, but are anticipated to be substantial.

b. Amounts borrowed will ultimately originate from U.S. and foreign banks or unaffiliated third parties.

c. [The taxpayer] and its U.S. affiliates do not advertise or hold themselves out to the public or business community as a source of funds, and they are not licensed or qualified to do business as banks or similar institutions.

d. Intercompany loans will be documented by written promissory notes for specific amounts or by written promissory agreements which specify the payment terms for aggregate unpaid principal amounts. All funds will be borrowed and lent at the same rates of interest, other than capital contributions which do not bear interest.

e. Principal and interest, if any, will be repaid in accordance with the terms of the notes. [The taxpayer] will charge the domestic affiliates the same interest rate as that which it obtains from foreign affiliates and domestic third parties.

[The taxpayer's] position is that, given the loan structure outlined in a. through e., the ultimate third-party lenders and not [the taxpayer] will be "engaging in banking, loan, security or other financial business" as referred to in RCW §82.04.4281. Similarly, interest income as contemplated by WAC 458-20-109 is attributable only to the third parties which originate the loans.

This position is consistent with Howard S. Wright Construction Co. et. al. v. Department of Revenue, Thurston County Superior Court Docket No. 79-2-01310-0 (1981) and is supported by Washington Department of Revenue Determinations 88-246 [6 WTD 89] and 90-145 [9 WTD 286-7]. These rulings provide that loans

procured by parent companies for their subsidiary companies from third-party lending sources on a straight pass-through basis do not derive taxable interest income.

(2) Cash Management System

The anticipated cash management system subject to consideration by the Washington Department of Revenue will have the following elements:

a.[The taxpayer] will utilize a dedicated bank account for the sole purpose of receiving and distributing surplus cash among majority-owned U.S. affiliates on a daily basis.

b.The dedicated account will maintain a constant balance of $3 million, which will be funded through an intercompany loan as described above, and will be supported by a $10 million line of credit facility at a Washington bank.

c.The dedicated account will be rolled into an overnight deposit account nightly.

d.Dedicated account balances in excess of $3 million will first be used to fund affiliates as required and then to pay off line of credit borrowings.

e.There will be no promissory notes or other written evidences of debt other than standard accounting records, and no interest will be charged.

[The taxpayer's] position is that cash management transfers will be exempt under RCW 82.04.4281, since the cash management structure outlined in points a. through e. adheres to the "bright-line test" defined in Washington Department of Revenue Determinations 88-246 [6 WTD 89] and 88-266 [6 WTD 175]. The "bright line test" has four requirements:

-Company funds are moved back and forth daily.

-All affiliates are majority owned by the same parent.

-There is no written evidence of indebtedness between the parties.

-The functions performed accomplish the same functions of money movement as those performed by a bank or other financial institution utilizing a daily target minimum or zero account balance method.

(3) Incidental Interest Income

[The taxpayer] will earn incidental bank interest income from short-term deposits, primarily overnight, of surplus cash. In this regard, [the taxpayer] is acting only as

> an agent on behalf of others. Consistent with [the taxpayer] acting as a conduit, bank interest attributable to an affiliate will be funded back to the appropriate affiliate. [The taxpayer] anticipates that such interest income will be exempted by RCW 82.04.4281 and cites John H. Sellen Construction Company v. Department of Revenue, 87 Wn. 2d 878, and Washington Department of Revenue [ETB] 505.04.109. According to these rulings, incidental interest income from the investment of surplus funds in interest bearing paper is exempt under RCW 82.04.4281.

The taxpayer projects that annual interest income from short-term deposits of surplus money management funds will be approximately $300,000. The collective gross income of the affiliates participating in the money management fund was [approximately $1,000,000,000] in 1990. Assuming that the affiliates' gross income will remain approximately the same, the short-term investment income of surplus money management account funds will be only 0.3% of the collective gross income of the participating affiliates.

The taxpayer states that it - analogous to a bank performing the same function - will have absolutely no beneficial interest in either the funds in the money management account or the short-term (overnight) investment income earned by surplus funds in that account.

The taxpayer requests that the Department confirm in writing its conclusions concerning each of the matters described above. In addition, it would like to know whether the interest bearing or noninterest bearing nature of the notes will be relevant.

ISSUES:

Four issues are raised by the taxpayer's petition:

Issue #1: If a Washington corporate taxpayer borrows funds from a third party in order to lend these same funds to a corporate affiliate at the same interest rate, therefore serving as a loan conduit, is the interest received by the taxpayer from the affiliate taxable?

Issue #2: When a taxpayer conducts no business activities of a nonfinancial nature, can its administration of a cash management system be exempt?

Issue #3: Can a taxpayer's activity of administering a cash management system be exempt if the taxpayer loans the cash management account amounts procured through the its own borrowing from a third party when the account balance falls below a minimum amount, and the loan is later repaid from the cash management account when the account balance is above the minimum amount?

Issue #4: Can a taxpayer with a cash management system invest cash management account funds in overnight short-term deposits and remain exempt from B&O tax on the interest earned?

RULING:

Issue #1 involves the borrowing of funds by the taxpayer in order to lend these same funds to a subsidiary or affiliate at the same interest rate.

The Superior court ruling in Howard S. Wright Construction, supra, is squarely on point with this case. That decision resulted from cross motions for summary judgment based upon a mutually agreed stipulation of facts.

The Court in that case concluded that there was no genuine issue of material fact between the parties. Stipulation of Fact No. 7 stated, "(t)he primary source of funds loaned to affiliates is borrowing by Wright and Schuchart from banks." Third party bank loans at the same rate of interest charged to the affiliate by Wright/Schuchart were the sources of the funds lent by the taxpayer.

The Department, in construing the Wright case, looks to the fact that a taxpayer merely acts as a conduit in the loan transaction, in that the interest paid to it equals the interest it owes the third party from which it obtained the funds. When there has been no object of financial gain or benefit to the taxpayer making the loan, the Department has held interest exempt.

[1] Thus, when a taxpayer acts as a conduit in procuring a loan from a third party lending source for the benefit of a related company on a straight pass-through (conduit) basis, and all interest charged and received by the taxpayer from the related company is repaid to the taxpayer's third party lender, tax is not due on such interest income.

Here, it appears the taxpayer will be making conduit loans similar to those in the Wright case. If the taxpayer is meticulous in making the conduit of lending and repayment clear in its books for the purpose of audit, the interest received by the taxpayer from these transactions will be exempt.

Issue #2 is whether a corporate affiliate which conducts no business activities of a nonfinancial nature can operate an exempt cash management system for the benefit of its affiliates.

Final Determination No. 86-309A, 4 WTD 341 (1987) provides background to the rationale for exempting cash management systems from the B&O tax:

> . . . The meaningful question is, then, does the taxpayer's activity of marshalling the profits and losses incurred by its subsidiaries through the application of internal money management techniques, derive additional, taxable value proceeding or accruing? In our view it does not, for two distinct and independently dispositive reasons.
>
> First, the money management techniques do not result in any actual payments or receipts to the taxpayer.[1] In its simplest sense, these activities merely result in

[1] Assuming no interest is legally enforceable.

> moving already taxed money from one pocket to another. No fee is charged and no consideration or value is actually received for this function.
>
> . . . Second, even if, arguendo, the expense of money management computed and designated as "interest" were deemed to result in value proceeding or accruing to the taxpayer [here at issue], the specific tax exemption of RCW 82.04.4281 would apply.
>
> The exemption statute provides in pertinent part as follows:
>
> > . . . In computing tax there may be deducted from the measure of tax amounts derived by persons, other than those engaging in banking, loan, security, or other financial businesses, from investment or the use of money as such. . . .
>
> Under this statute there are two criteria for exemption. (a) The amounts must be derived from "investments or the use of money as such," and (b) The recipient of such amounts must not be a "financial business." Both criteria [must be satisfied]. Our analysis of the money management technique . . . reveals that it is simply the "use of money as such." It does not constitute the making of loans or other investments in any traditional sense, nor is it supported by any of the legal evidences of rights and obligations flowing between the taxpayer and its subsidiaries. Rather, it is precisely the kind of marshalling of assets which is contemplated by the statutory language, "use of money as such."

[Final Determination 86-309A, 4 WTD 341 (1987)]

The taxpayer in this case satisfies the requirements of the first example set forth above, in that the taxpayer will not charge interest. If interest were to be received, the cash management activity would be subject to B&O tax, since this particular taxpayer would be deemed to be a financial business due to its lack of any other nonfinancial business activity.

[2] Thus, money management activity by a taxpayer without any nonfinancial business activity may be exempt from B&O tax for its money management activity only if interest is not received.

Issue #3 involves the taxpayer's proposal of insuring that the money management account maintains at least a $3 million balance by borrowing money through a line of credit in its own name and then lending it to the fund. The taxpayer will then pay off the loan (both principal and interest) directly from the cash management account when that account balance exceeds $3 million. Technically, then, the cash management fund would be repaying the taxpayer's loan.

Although repayment of the taxpayer's loan from the fund (including both surplus operating funds and short-term overnight interest earned thereon) is technically a benefit to the taxpayer, this benefit is clearly neither "bargained for" nor an inducement to engage in the money management activity itself. In this particular instance, the money the taxpayer will borrow in its own name will be used

solely for the benefit of the money management account, and repayment in the exact amount of principal and interest incurred by the taxpayer will be made directly from that account. The taxpayer will not realize a profit nor does it intend to. Although not precisely identical, this factual situation is similar to that in the Wright case in Issue #1 above.

[3] Accordingly, an otherwise exempt cash management activity will not be rendered taxable merely because the managing corporate taxpayer borrows money in its own name in order to maintain a minimum balance in the cash management account, and then repays the loan from the money management account when funds over the minimum balance are available.

Issue #4 concerns a claim for B&O exemption of interest income derived from the short-term (overnight) investment of money management funds. The taxpayer claims that exemption is appropriate under RCW 82.04.4281.

RCW 82.04.4281 provides in pertinent part as follows:

> In computing tax there may be deducted from the measure of tax amounts derived by persons, other than those engaging in banking, loan, security, or other financial businesses, from investments or the use of money as such. . . .

[Emphasis added.]

A "financial business," for purposes of RCW 82.04.4281 which allows exemption from business and occupation taxes for investment income by persons other than financial businesses, is a business whose primary purpose and objective is to earn income through the handling and investment of a significant amount of funds. John H. Sellen Construction v. Department of Revenue, 87 Wn.2d 878, 882, 558 P.2d 1342 (1976) and Rainier Bancorporation v. Revenue, 96 Wn.2d 669, 672 673, 638 P.2d 575 (1982). However, the Sellen court went on to quote with approval the following language of ETB 368.04.224 (June 12, 1970):

> But it does not follow that every act of business or every investment and grant of the use of money is held to be financial business. . . . Where the activities involved are essentially in competition with financial businesses and this is a regular part of the taxpayer's normal business practice, the department believes that the activities constitute financial business.

After Sellen was decided, the Department of Revenue issued ETB 505.04.109 which, speaking of the case, stated in pertinent part:

> Under the holding of the [Sellen] court the income items listed met the two conditions for the deduction of RCW 82.04.430(1) [now 82.04.4281]:
>
> 1.they were amounts derived from investments and
>
> 2.the business activity did not constitute financial business.

In the course of its decision the court gave its endorsement to ETB 368 and quoted with approval the following language therefrom:

> Where the activities involved are essentially in competition with financial businesses and this is a regular part of the taxpayer's normal business practice, the department believes that the activities constitute financial business and are subject to tax.

The court did not define "investments" in its opinion. However, it noted that enterprises "specializing in the handling and investment of funds" would not be entitled to the statutory deduction but that those "making incidental investment of surplus funds" should receive the deduction.

Under the holding of the court in Sellen, income from the incidental investment of surplus or excess funds by persons who are not themselves in a security, investment, or financial business is not subject to tax.

However, no deduction is permitted with respect to

1.interest or similar charges from extension of credit to customers;

2.interest or similar financial charges relating to real estate transactions (see RCW 82.04.390); nor

3.income from activities which are essentially in competition with financial businesses where such activities are a regular part of the taxpayer's normal business practice.

[Emphasis added.]

For purposes of RCW 82.04.4281, a "security, investment, or financial business" is a business whose primary purpose and objective is to earn income through the handling and investment of a significant amount of funds, where such activities are essentially in competition with other financial businesses and are a regular part of the taxpayer's normal business practice.

In this case, the Department is satisfied that, in substance, the taxpayer will be investing money management funds in overnight deposits on behalf of and for the direct benefit of only those participating in the money management fund, and not for its own benefit. Interest earned will be credited in full directly to the fund - and thus indirectly to the taxpayer's affiliates for whose benefit the fund is managed. The taxpayer will have no beneficial interest in amounts so earned, will derive no financial benefit from either managing or investing the fund. Basically, the taxpayer will serve merely as a conduit in this investment activity.

Likewise, the taxpayer's affiliates on whose behalf the taxpayer invests are not "security, investment, or financial business[es]." They actively engage in business in various aspects of the construction industry.

Moreover, although the taxpayer will perform certain necessary financial functions for the corporate family and will have no other nonfinancial business activity, the Department does not consider it to be a "security, investment, or financial business" for purposes of RCW 82.04.4281. This is because it will neither engage in these financial transactions with the object of gain for itself; nor will it be in competition with other financial businesses.

Since neither the taxpayer nor the affiliates for whose benefit the fund is maintained are "security, investment, or financial business[es]," the question then remains as to whether the investment activity will be an "incidental investment of surplus funds." To determine whether an investment activity is "incidental," the Department has consistently, since the 1976 Sellen case, supra, considered or given weight to the degree investment income contributes to a taxpayer's total gross income.

Neither the Department nor courts have ever held investment income of over 3 or 4% of a taxpayer's total gross income to be "incidental." Although we do not adopt a strict percentage test for deciding whether investment activity is "incidental," it is considered a significant factor.

In this case, the taxpayer projects that annual interest income from short-term deposits of surplus money management funds will be approximately $300,000. The collective gross income of the corporate affiliates participating in the money management fund -those on whose behalf the funds are invested - was [approximately $1,000,000,000] in 1990. Assuming that these affiliates' gross income will remain approximately the same or grow, the short-term investment of surplus money management account funds would be only 0.3% or less of the collective gross income of the participating affiliates. An amount of investment income equalling only 0.3% of gross income will be considered de minimis incidental, and insufficient to constitute the taxpayer a "financial business."

[4] Thus, to summarize: When a taxpayer who administers an otherwise exempt cash management system for its affiliates makes short-term (overnight) investments of surplus cash management funds, it will be exempt from B&O tax on investment interest so earned under the following circumstances:

(1)the taxpayer is not a "security, investment, or financial business" under RCW 82.04.4281, in that it (a) performs financial functions only for its corporate affiliates with no object of gain, and (b) is not in competition with other "security, investment, or financial businesses,"

(2)the taxpayer has no beneficial interest in interest earned on the funds, which interest is deposited directly into the money management fund,

(3)the affiliates for whose benefit the fund is managed are not "security, investment, or financial business[es]" and

(4)interest derived on the fund's behalf is incidental and de minimis in comparison with the total gross income of the participating affiliates.

It appears that the taxpayer in this case will meet the above criteria, and will thus be exempt from B&O tax on interest income earned on short-term (overnight) deposits of surplus funds in the money management fund account it controls.

DATED this 18th day of April, 1991.