

Cite as Det. No. 92-250, 12 WTD 409 (1992).

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 Correction of Assessment of)	
)	No. 92-250
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. . .)	Registration No. . . .
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- [1] MISCELLANEOUS -- JOINT VENTURE/PARTNERSHIP. The taxpayer enters into underwriting agreements with other under- writers. Where the terms of the agreements require that the taxpayer name a lead underwriter to represent it in the sale of the securities and they state that the underwriters are not partners, the Department will acknowledge the express contract terms.
- [2] WAC 458-20-162 -- GROSS INCOME FROM BUSINESS -- GAINS FROM THE TRADING IN SECURITIES. Where the taxpayer appoints another underwriter to act as its representative in an underwriting syndicate, the gross amount received by its representative will be treated as being received by the taxpayer. No deduction for the lead underwriter's costs will be allowed.
- [3] WAC 458-20-162 -- LOSSES FROM TRADING IN SECURITIES. Where the taxpayer appoints a lead underwriter to perform oversales and stabilization purchases on behalf of the members of a syndicate the taxpayer's proportionate share of any losses incurred in those activities is deductible from gains derived from trading in securities. These losses will be deductible in the month when the lead underwriter makes its accounting of the syndicate to the taxpayer.

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: . . .

NATURE OF ACTION:

The taxpayers protest the assessment of business and occupation tax found to be due by the Department's auditor on gross amounts received from a syndication where the taxpayers had reported the net amount received.

FACTS:

Coffman, A.L.J. (as successor to Heller, A.L.J.) -- [The taxpayer] is the successor to [A]. Their appeals have been consolidated for administrative convenience because the legal issues are identical in both cases. The books and records of [A] were reviewed by the Audit Division for the period of January 1, 1985 through May 31, 1987. Tax Assessment No. . . . was issued [in December 1989] showing \$. . . due and owing. The books and records of [the taxpayer] were reviewed for the period of June 1, 1987 through December 31, 1988. Tax Assessment No. . . . was issued [in December 1989] showing \$. . . due and owing. Each taxpayer has made partial payments of the undisputed amounts.

We will refer to both entities as the taxpayer. The taxpayer is a stock brokerage firm with seats on several stock exchanges As part of its brokerage business the taxpayer will occasionally participate in stock syndications. A stock syndication is an arrangement where several brokerage houses agree, pursuant to a written agreement, to commit to an issuer of previously unregistered stock to purchase a specified number of shares or other securities. This is referred to as an underwriting syndication and the individual members are called underwriters. The purpose of the syndication is to assure the issuer that it will receive a guaranteed influx of capital while providing the underwriters with the potential to reap the profits on "hot issues."

The taxpayer has stated that each underwriting syndication is different; however, the essential terms remain constant. The taxpayer provided the Department with the various agreements involved in one such underwriting syndication and stated that the terms were typical of all such agreements. In the example provided, three agreements were signed: an agreement between the various underwriters; an agreement between the underwriters and the issuer; and an agreement between the domestic syndication and a foreign syndicate.

The process by which the underwriting syndication is established is generally as follows: The party desiring to issue the securities will contract with a brokerage house to assist it in bringing the securities to market. This brokerage house is known as the lead underwriter. The lead underwriter then contacts other brokerage houses to determine if they desire to participate and the extent to which they will. Each member of the underwriting syndicate agrees to purchase severally a specific number of shares from the issuer at a specific price. Each underwriter also agrees that, if any underwriter fails to participate, the remaining underwriters will purchase the shares of the defaulting underwriter on a pro rata basis. This agreement is subject to a percentage limitation. Each member is only liable to the issuer for the number of shares so specified.

Under the terms of the underwriting syndication agreement, the lead underwriter is appointed the representative of each member with the power to modify the agreement, alter the number of shares purchased, sell shares for their account, and incur expenses relating to the offering which the member must pay. These expenses include management fees, service compensation, general expenses, and oversales and stabilization costs.

The taxpayer explains oversales and stabilization as follows:

When an underwriting syndicate enters into an agreement with an issuer to bring a securities issue to market, industry practice generally requires the lead underwriter, on behalf of the syndicate, to take appropriate measures to ensure not only that the entire issue is sold but also that an orderly trading market for the new issue develops at prices related to the new issue price. To ensure the entire issue is sold, the syndicate will generally "oversell" the issue, by obtaining more purchase orders than there is stock to sell. The syndicate, at this point, has a "short" position in the stock (i.e., it has sold stock it does not own), which it eventually must cover by buying stock in the open market. If there is upward market pressure on the stock, the syndicate will absorb a loss because it must pay more to buy the stock than it received when it was sold in the original offering. The lead underwriter charges these losses to the amounts otherwise distributable to the syndicate members in proportion to their respective allotments of the entire new issue.

The converse of this is stabilization. Simply stated, this involves the lead underwriter buying and selling the issue in the open market at prices related to the

offering price to prevent the short term downward price pressure on the new issue. Once the lead underwriter determines that an orderly trading market for the new security has developed and the price of the new issue has stabilized at the appropriate level, it discontinues stabilization activities and charges the losses from trading against the amounts otherwise distributable to other syndicate members in proportion to their respective allotments of the entire new issue.

Each member's compensation is paid after the completion of the sale of the securities and consists of the price received for the allotted shares less the price paid to the issuer and the expenses of the lead underwriter. If all securities are not sold, the taxpayer will receive the unsold securities subject to the payment of the price stated in the underwriting agreement.

The taxpayer has paid business and occupation taxes on the net distribution from the lead underwriter, however the Department's auditor assessed tax based on the expenses of the lead underwriter on the theory that no deduction is allowed for them.

ISSUES:

1. Is an underwriting syndicate a joint venture? If it is a joint venture, are the gross receipts of the underwriting syndicate subject to tax in the state of Washington?
2. What is the measure of the taxpayer's gross receipts from an underwriting syndicate? Is this measure the gross amount received by the main underwriter or the net amount paid to the taxpayer?
3. If the measure is the gross receipts of the main underwriter, is the taxpayer entitled to a deduction for oversales and stabilization costs?

DISCUSSION:

1. Joint Venture.

[1] A joint venture is in the nature of a partnership. Barrington v. Murry, 35 Wn. 2d 744 (1950). Further, a joint venture is a consensual relationship. Salter v. Heiser, 39 Wn. 2d 826 (1952). The sample agreement among underwriters provided by the taxpayer states:

In taking all actions hereunder, except in the performance of our own obligations hereunder and under the Underwriting Agreement, we [lead underwriters]

shall act only as representatives of each of the Underwriters. . . . Nothing contained herein shall constitute the Underwriters partners or render any of them liable to make payments otherwise than as herein provided.

(Bracketed material added.)

The underwriting agreement with the issuer provided that the each underwriter was agreeing severally and not jointly to purchase shares. Further, the issuer agreed with each underwriter to conditions concerning the prospectus. Likewise, the issuer agreed with the several underwriters to pay certain costs.

The taxpayer argues that: "Even the Internal Revenue Code defines the term 'partnership' to include a 'syndicate.' Internal Revenue Code sec. 761(a)." This is not relevant to our determination. I.R.C. §761(a)(3) provides that syndicates such as those at issue may be excluded from the definition of a partnership for federal income tax purposes. Further, W. McKEE, W. NELSON, and R. WHITMORE, Federal Taxation of Partnerships and Partners, (1978), ¶3.01[1] states:

... an enterprise may be classified as a partnership for [federal] tax purposes even though it is not, or could not, be a partnership under a state partnership statute. Conversely, the fact that a joint enterprise is a partnership under state law is not dispositive of its classification for federal income tax purposes.

(Footnotes omitted and bracketed material added.)

The underwriters did not view themselves as partners or joint venturers. Further, the issuer did not treat them as such. Under these circumstances it is appropriate for the Department to accept the taxpayer's agreement for what it says - no partnership or joint venture existed.

2. Measure of the Tax.

RCW 82.04.290 reads, in part:

Upon every person engaging within this state in any business activity other than or in addition to those enumerated in RCW 82.04.230, 82.04.240, 82.04.250, 82.04.255, 82.04.260, 82.04.270, and 82.04.280; as to such persons the amount of tax on account of such activities shall be equal to the gross income of the business multiplied by the rate of 1.50 percent.

The "gross income of the business" is defined in RCW 82.04.080 as:

"Gross income of the business" means 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 added.)

In this case the taxpayer purchased from the issuer certain specified quantities of stock for a specified cost. These shares were then sold on the open market by the taxpayer's representative for a price. Thus, the maximum amount which would be subject to tax would be gross profit. Gross profit is the amount received for the security over and above the cost of the security. The Department's rule, WAC 458-20-162, states that:

With respect to stockbrokers and security houses, "gross income of the business" means the total of gross income from interest, gross income from commissions, gross income from trading and gross income from all other sources: PROVIDED, That:

(1) Gross income from each account is to be computed separately and on a monthly basis;

(2) Loss sustained upon any earnings account may not be deducted from or offset against gross income upon any other account, nor may a loss sustained upon any earnings account during any month be deducted from the gross income upon any account for any other month;

(3) No deductions are allowed on account of salaries or commissions paid to employees or salesmen, rent, or any other overhead or operating expenses paid or incurred, or on account of losses other than under "2" above;

(4) No deductions are allowed from commissions received from sales of securities which are delivered to buyers outside the state of Washington.

. . .

GROSS INCOME FROM TRADING. Gross income from trading is the amount received from the sale of stocks, bonds and other securities over and above the cost or purchase price of such stocks, bonds and other securities. In the case of short sales gross earnings shall be reported in the month during which the transaction is closed, that is, when the purchase is made to cover such sales or the short sale contract is forfeited.

(Emphasis added.)

[2] RCW 82.04.080 does not provide for any deduction for management fees, service fees, or any other cost. These costs are the costs of doing business the same as salary costs for the taxpayer's employees or facility costs. If the taxpayer were to directly incur the management fees and service fees, the fees would not be deductible from the gross receipts. The lead underwriter was acting merely as the representative of the taxpayer when it incurred these costs. The amount received by the lead underwriter as the representative of the taxpayer must be treated as being received by the taxpayer. Therefore, the costs are not deductible.

3. Oversales and Stabilization costs.

The taxpayer states in its petition:

. . . the syndicate's distribution of the new issue is akin to a large inventory position that it must try to place in investor's hands at or about a certain price. The arrangements with the purchasers of the shares are typically made days or even weeks in advance, and, when the new issue comes to market, some of these purchasers may have changed their investment decisions. Depending on the state of the market for the new issue, the syndicate may have to buy and sell stock on the open market, which often results in some trading losses. Since the syndicate buys the entire new issue as principal, and sells the entire new issue as principal, its trading profits are what is left over after the entire distribution has been completed. Thus under WAC 458-20-162, the gross income attributable to the syndicate is more properly characterized as the trading profits attributable buying and selling the syndicate position, i.e., the syndicate's gross receipts from the sale of the new issue (the price paid by the syndicate's customers) less the price for the securities (what it must pay to the issuer) less the trading losses attributable to distributing the new issue to investors (trading losses due to stabilization

activities or covering short positions from oversales). We therefore submit that taxpayer's portion of the syndicate's stabilization and oversales expenses, at least, is unquestionably excluded from the gross receipts under WAC 458-20-162. . . .

We agree that the losses from oversales and stabilization are trading losses. Losses are the amount by which the purchase price exceeds the sales price. Other administrative costs cannot be included. As such they are deductible per WAC 458-20-162(2) to the extent that are used to offset gains in the same month. The taxpayer only receives a single accounting of the syndication, thus we will treat these losses as occurring at the same time the sale of the taxpayer's portion of the stock in the syndicate.

DECISION AND DISPOSITION:

The taxpayer's petition is granted in part and denied in part. The file will be returned to the Audit Division to recalculate the amount due after allowing deductions for oversales and stabilization costs.

DATED this 8th day of September 1992.