Cite as Det. No. 92-128, 12 WTD 165 (1993)

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 the Prior Determination of Tax Liability for	)	D E T E R M I N A T I O N
	)	No. 92-128
. . .	)	

[1] RULE 156: ESCROW -- EXCHANGE FACILITATOR. Fees paid to a facilitator to hold funds from sales of real estate to be used to purchase like kind property for tax deferred exchanges under I.R.C. §1031 are retail sales.

[2] RCW 82.04.4281: B&O TAX -- INTEREST INCOME -- EXCHANGE FACILITATOR. Interest earned on funds held to purchase property for an I.R.C. §1031 transaction may be exempt from B&O tax if it meets the requirements in ETB 505. However, if the interest is in lieu of a fee paid to the facilitator, it will be subject to tax as a retail sale.

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:

An attorney requested a prior determination of tax liability under WAC 458-20-100(9) on behalf of an undisclosed client (hereafter also referred to as "taxpayer" or "facilitator"). The Taxpayer Information and Education Section issued a letter. The taxpayer subsequently requested a redetermination of that opinion by this office.

FACTS AND ISSUES:

Pree, A.L.J. -- The taxpayer acts as a facilitator for property exchanges under Internal Revenue Code Section 1031. That section provides for tax deferral of gains on qualifying exchanges of investment and income producing property. Under the authority of that section, tax planners may avoid tax normally incurred when someone is selling property, by finding a third person to acquire other property that the seller would take instead of cash thus deferring income that would otherwise be taxable. The IRS regulations prohibit the seller from taking control over the funds.

The taxpayer, acting as the third-party facilitator, takes title to the seller's property, sells it, purchases exchange (replacement) property, and then transfers the replacement property to the original seller. Because that seller does not realize the cash from the sale of the property, it is considered a like-kind exchange, and the gain realized, if any, by that seller may be deferred under the federal tax provisions.

For acting as facilitator, the taxpayer charges fees for providing the exchange service. It also receives interest income on the funds it holds until the replacement property is acquired.

The Taxpayer Information and Education Section considered the facilitator to be providing an escrow service, a retail sale under RCW 82.04.050. As such, the facilitator was required to collect retail sales tax on its fees.

The facilitators were considered to be in competition with financial businesses. As such, the interest income was subject to business and occupation tax at the service and other activities rate.

The taxpayer contends that the service is not an escrow service taxable as a retail sale. In addition, the taxpayer asserts that the interest income was excludable. The issues are:

[1] Does the facilitator activity of the taxpayer constitute an escrow service taxable as a retail sale?

[2] Is the interest received by the taxpayer on funds held until replacement property is acquired subject to tax?

DISCUSSION:

[1] RCW 82.04.050 includes fees for escrow services in the definition of retail sale. WAC 458-20-156 (Rule 156) defines "escrow":

> The term "escrow" means any transaction wherein any person or persons, for the purpose of effecting and closing the sale, purchase, exchange, transfer, encumbrance, or lease of real or personal property to another person or persons, delivers any written instrument, money, evidence of title to real or personal property, or other thing of value to a third person to be held by such third person until the happening of a specified event or the performance of a prescribed condition or

> conditions, when it is then to be delivered by such third person, in compliance with instructions under which he is to act, to a grantee, grantor, promisee, promisor, obligee, obligor, lessee, lessor, bailee, bailor, or any agent or employee thereof.

The Department's definition of escrow is identical to the definition of escrow as found in RCW 18.44.010 of the Escrow Agent Registration Act and is consistent with the definition of escrow in Lechner v. Halling, 35 Wn.2d 903, 912 (1950):

> In the early case of Bronx Investment Co. v. National Bank of Commerce, 47 Wash. 566, 92 P. 380, 381 we defined an "escrow," taking the definition from 16 Cyc. 561, as follows: "'An escrow is a written instrument, which by its terms imports a legal obligation, deposited by the grantor, promisor, or obligor, or his agent with a stranger or third person . . . to be kept by the depositary until the performance of a condition or the happening of a certain event, and then to be delivered over to take effect.'"

(Emphasis in original.)

The property is held by the facilitator, a third party, until the happening of a certain event, the identification and purchase of exchange property. It is clear that the facilitator's activity meets the definition of escrow.

Unlike other businesses, escrow businesses do not pay taxes on the gross transaction amount. Rather, their fees are deemed retail sales and retail sales tax is due on them. Regarding real estate excise taxes, we do not subject facilitators to tax on both legs of the transaction. We consider them similar to nominees exempt on the subsequent transaction under WAC 458-61-550.

The exchange facilitator benefits by not paying real estate excise tax on one leg of the transaction. A truly independent party would be required to pay the tax. The exchange facilitator does not pay business and occupation taxes on the gross amount. It would not only be contrary to the language of Rule 156 but also inconsistent with the theory behind it to find that the facilitator is not acting in an escrow capacity. Since the facilitator is acting in an escrow capacity, the fees are taxed as retail sales subject to retail sales tax.

[2] RCW 82.04.4281 provides authority for exempting interest income from business and occupation taxes stating:

> 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, and also amounts derived as dividends by a parent from its subsidiary corporations.

In John H. Sellen Constr. Co. v. Department of Rev., 87 Wn.2d 878, 883 (1976), the Washington Supreme Court limited the interpretation of "investment" to the plain and ordinary meaning allowing a deduction for income from a business' incidental investments of surplus funds. ETB

505.04.109, issued March 4, 1977 is the Department position following that decision which requires us to look at the facts and circumstances of each taxpayer to determine whether or not the amounts received as interest are exempt. It is not clear from the information available whether the interest on these funds is excludable by the taxpayer.

ETB 505 provides that under the holding of the Sellen court the interest income must meet two conditions for the deduction of RCW 82.04.430(1):

1. they were amounts derived from investments and

2. the business activity did not constitute financial business.

ETB 505 goes on to acknowledge that the court ratified the Department's stated position in a prior ETB:

> 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 nature of the taxpayer's business must be established. If it specializes in handling investments, no deduction will be allowed. The ETB concludes by outlining transactions that do not qualify for the deduction:

> 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.

The transactions involving facilitators are peculiar in that it is difficult to determine upon whose funds the interest is earned. Certainly, the funds are held by the facilitator with the understanding that they will only be used to purchase designated property. Otherwise, they will be returned to the original seller. They are not necessarily the property of the facilitator. The financial institution paying the interest considers the amount paid to be interest. However, it is not necessarily appropriate to consider the amount received by the facilitator interest. It may be a negotiated amount in lieu of a fee to act as a facilitator. All the facts and circumstances of a particular transaction need to be reviewed.

If the amount of the interest paid in the transaction is in lieu of an escrow fee, it would be classified as a retail sale, subject to retail sales tax. If it is interest, it should be analyzed under the guidelines in ETB 505, and if not exempt but taxable as interest rather than in lieu of a facilitator's fee, taxed under the service classification.

DECISION AND DISPOSITION:

Generally, we agree with the conclusions of the Taxpayer Information and Education Sections ruling regarding the taxpayer's situation. Taxpayers are entitled request a ruling pursuant to WAC 458-20-100(9). Normally, a taxpayer would be permitted to rely upon the ruling for reporting purposes and as support of the reporting method in the event of an audit. The identity of the taxpayer has not been disclosed in this request for a ruling, and the ruling is based upon only the facts that were disclosed by the taxpayer's representative. Since we will not be able to inform the taxpayer of any future changes in our position, this ruling may not be effective for future application by the taxpayer and will not necessarily be binding on the Department should the position of the Department change. It also shall not be binding if there are relevant facts which are in existence but not disclosed at the time this opinion was issued; if, subsequently, the disclosed facts are ultimately determined to be false; or if the facts as disclosed subsequently change and no new opinion has been issued which takes into consideration those changes.

DATED this 22nd day of May 1992.