Cite as Det. No. 94-035, 14 WTD 199 (1995).

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

In the Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 94-035
. . .	)	Registration No. . . .
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[1] RULE 109: B&O TAX -- EXEMPTION -- CASH MANAGEMENT -- INTEREST CHARGED. In accordance with the requirements of 1.a. of the "bright line test" under Final Det. 86-309A, 4 WTD 341 (1987), a taxpayer may not retain interest earned on the investments of other entities for exemption of the cash management interest per Det.

No. 91-096, 11 WTD 123 (1991). See also Final Det. No. 88-246, 6 WTD 89 (1988); Det. No. 93-324.

[2] RULE 193C: SERVICE B&O -- BUY-SELL FSC -- 85% SAFE HARBOR -- ECONOMIC PROCESS COSTS. A buy-sell foreign sales corporation may not deduct economic process costs or exclude payments for its services unless those services were provided outside of Washington or the payments qualify as advances or reimbursements under Rule 111.

[3] RCW 82.04.090: WHOLESALING B&O -- CHIP EXCHANGES. The value of wood chips received by a pulp mill in exchange for chips previously provided or to be provided later to other mills must be included in gross proceeds of sales. Longview Fibre Company v. Department of Rev., BTA Docket No. 12685 (December 30, 1975).

[4] RULE 193C: SERVICE B&O -- FOREIGN SALES CORPORATIONS -- PROFIT ADJUSTMENT. Adjustments under IRS guidelines for transfer pricing involving foreign sales corporations are not taxable for goods delivered outside of Washington.

[5] RULE 111: REIMBURSEMENTS -- WORKERS' COMPENSATION -- INDUSTRIAL INSURANCE CLAIMS ADMINISTRATION. Administrative subsidiary providing bookkeeping services for a self-insured affiliated group may exclude reimbursements from affiliates for time-loss compensation and medical costs it paid as agent. It may not exclude payments for its administrative services and other costs for which it was liable.

[6] RULE 226: USE TAX -- VALUATION -- FIRST USE -- SEEDS -- TREES. Use tax is due when tree seeds or seedlings are first used (planted) in Washington. Tree seedlings raised by third parties from seeds upon which the taxpayer paid retail sales tax are not subject to use tax when they are returned to the taxpayer.

[7] RULE 173: USE TAX -- REPAIRS -- OUT-OF-STATE. Use tax is due on the value of new parts installed into equipment repaired out-of-state and returned to Washington. Det. No. 90-298, 11 WTD 067 (1990) and ETB 421.

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:

An affiliated group of forest product companies protest assessments.[1]

FACTS AND ISSUES:

Pree, A.L.J. -- A group of corporations is engaged in various forest product businesses and may hereinafter be referred to collectively or individually as the taxpayer. They may also be referred to as affiliates.

Some issues are common to several entities and assessments. We will outline the facts by issue and discuss them in the same order.

[1] Investment income. The Audit Division of the Department of Revenue (Department) assessed service and other B&O tax on investment income. After submitting its petition, the taxpayer asserts that its investment activity qualifies as a nontaxable money management system. It states that it meets the following four requirements of the bright line test in Final Det. No. 86-309A, 4 WTD 341 (1987):

> 1) Company funds are moved back and forth between entities or accounts within the internal business structure on a daily basis;
>
> 2) The subsidiary or affiliated entities whose daily operations are funded in this manner are majority owned and controlled by the same parent or its owners;
>
> 3) There are no written evidences of indebtedness memorializing the funding activity and creating any creditor-debtor relationship between the parties, on either a demand or term payment basis;
>
> 4) The functions performed to accomplish the money movement between entities or accounts are the same as those performed by banks and other financial institutions, utilizing a daily targeted minimum or zero account balance method.

Neither the auditor nor the taxpayer considered this test prior to the assessment, and the facts as asserted now by the taxpayer have not been verified.

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[1]Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

In the alternative, if its activity fails to qualify as a nontaxable money management system, the taxpayer contends that the investment income is exempt under RCW 82.04.4281.

[2] Foreign Sales Corporation's reimbursable expenses. The taxpayer's foreign sales corporation entered on its books credits for "reimbursable expenses" regarding economic process costs. These costs are necessary to qualify as a foreign sales corporation for federal income tax purposes. Similar offsetting credits appear on the books for affiliates.

The auditor was only able to review a single ledger sheet regarding the nature of these expenses. The taxpayer states that it does not object to a review of the invoices and other records which more accurately describe the nature of the expenses and indicate who was liable for them.

[3] Chip exchanges. The taxpayer purchases wood chips to manufacture linerboard, sack paper, and market pulp in its integrated pulp/paper mill. It constantly needs the chips. It states that it operates the production processes at least 355 days a year, 24 hours a day. It is "open" to receive wood chips 24 hours a day 365 days a year.

Sawmills or plywood plants produce wood chips as a by-product of their manufacturing processes. Also, "chip mills" or "woodrooms" manufacture them from debarked logs of low quality not suitable for lumber or other uses. The taxpayer does not manufacture the chips, but purchases them from other entities.

It exchanges chips with other pulp or paper mills and chip export facilities. The taxpayer explains that as an accommodation to each other, the mills agree to "exchange" like volumes, species and quality of chips. No written agreements were available at the hearing.

Each entity keeps accurate records of the chips using the industry's standard measurement system of bone dry tons (BDT) or bone dry units (BDU). For on-going exchanges, the parties share data and keep an arithmetic balance agreed to by the respective accounting departments. Managers who procure the chips attempt to maintain a balance near zero between exchange partners.

The taxpayer states that it does not enter the exchange agreements for the purpose of making sales to others. It lists the following reasons for exchanging the chips: (a) accommodate inventory excesses/deficits; (b) alleviate traffic congestion; (c) accommodate production schedules; (d) minimize railcar or barge demurrage costs; and (e) minimize or eliminate excess waiting time for truck deliveries.

Either party may terminate an exchange agreement. If they terminate an agreement, the parties try to balance the exchange by a specified date. If unable to zero out a balance, the party who received more chips makes a final cash payment to the other party for the additional chips. The taxpayer agrees that the final payment is taxable. The taxpayer states that it is unaware of any situation where a chip exchange was terminated or a settlement amount paid.

The auditor assessed wholesaling B&O tax on all the exchanges.

[4] Foreign Sales Corporation profit adjustment. At the end of each year, the taxpayer would compute the maximum gross profit allowable for the foreign sales corporation then enter a "profit adjustment" for the taxpayer to receive the maximum income tax benefit. The Audit Division originally included this amount in the assessment, but now agrees to remove it.

[5] Industrial claims administration. According to the taxpayer, all the affiliates are self-insured for workers' compensation. The taxpayer also points out that because it publishes a consolidated financial statement, the Department of Labor & Industries (L&I) considers the parent company the actual entity that L&I audits. However, an affiliate actually processes the claims.

For instance, if a worker for any affiliate is injured on the job, the medial bills are sent to the taxpayer. The taxpayer pays them only to the extent allowed by L&I. Similarly, when an employee is unable to work, the taxpayer pays the employee benefits for lost time based on a formula mandated by L&I. That formula factors in the injured worker's regular earnings, marital status and number of dependents.

At the end of every month, the taxpayer reports the total claim payments for each injured worker. The taxpayer bills each affiliate for payments on behalf of the affiliate's injured workers. These bills reflect only actual outlays without any markup. The Audit Division assessed service and other business and occupation (B&O) tax on these payments. The taxpayer disputes this assessment, arguing that as an agent of the affiliate, amounts received for these expenses are not subject to B&O tax.

The taxpayer also bills the affiliates for its overhead expenses. At the end of each year, the taxpayer totals its expenses in administrating the self-insured workers' compensation plan. The total does not include the disputed medical and time-compensation payments. The taxpayer includes other program costs such as bonding and excess insurance (i.e., coverage for claims which exceed a certain amount). It then bills each affiliate

proportionate to the claims paid on behalf of the affiliate's injured workers. The taxpayer paid B&O tax on these payments and does not dispute that they are taxable.

The taxpayer only disputes the taxability of the payments from the affiliates for direct medical bills and time-compensation paid by the taxpayer.

[6] Seedlings. The taxpayer harvests timber from trees it grows from seeds or seedlings. Tree seedlings are raised by third parties growers from seeds that the taxpayer supplies. The growers raise the tree seedlings in Washington. The taxpayer receives back the tree seedlings from its seeds after the specified growing period. The taxpayer paid sales or use tax on the seeds that it provided.

Use tax was assessed and paid on the value of the seedlings. The taxpayer disagrees with the Department that use tax was due on the value of tree seedlings raised by third party growers from the taxpayer's seeds. The taxpayer maintains that use tax liability arises as to that first use in the state and no additional liability arises with respect to any subsequent use by the same person.

In contrast, the Department maintains that tree seeds are different "products" than tree seedlings and that there is value added when the tree seeds are grown to tree seedlings. Furthermore, the Department contends that the taxability occurs at the time the seedling trees are put to use by the taxpayer as a consumer (planting). For purposes of the audit the value of the untaxed seedling trees was determined by grower charges to the taxpayer for growing seeds into seedling trees.

The issue is whether use tax is due on the increased value of tree seedlings raised from the taxpayer's seeds.

[7] Out-of-state repair. The taxpayer sent some of its Washington equipment out-of-state for repairs. After the equipment arrived back, the Audit Division assessed use tax on the total paid for the repairs. The auditor advised the taxpayer that only the charge attributable to the repair parts or material incorporated into the repaired equipment was subject to tax. Out-of-state repair labor was not subject to the tax.

The taxpayer contends that the basis for this assessment is inconsistent with the Department's position in TRAMCO, Inc. v. Department of Rev., Thurston Co. Cause No. 92-2-01429-4.

DISCUSSION:

[1] Investment income. The Audit Division needs to review the taxpayer's records to determine whether or not it meets the requirements of Final Det. No. 86-309A, 4 WTD 341 (1987). In addition, Det. No. 91-096, 11 WTD 123 (1991) provided that a company which essentially conducts no business activities of a nonfinancial nature can operate an exempt cash money management system if the following additional criteria are met:

> (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.
>
> . . . 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. (Emphasis added).

Det. No. 91-096, at 130.

The Department has uniformly held that cash management activities will be exempt only when the activity is devoid of direct financial benefit in the way of interest retained by the taxpayer. Therefore, in accordance with requirement 1.a. of the "bright line test" set forth in Det. No. 86-309A, the taxpayer may not earn or retain the interest income of the affiliates. The Audit Division needs to review the taxpayer's records to determine if these requirements were met.

[2] Foreign Sales Corp reimbursable expenses. ETB 558.04.193C/224 explains the business and occupation (B&O) tax liability of Foreign Sales Corporations (FSCs) stating in part:

> The B&O tax liability of a FSC depends on whether it operates on a direct buy-sell basis or on a commission

basis. If a FSC operates on a commission basis, its B&O tax liability depends on whether it is a "Regular" or "Small" FSC.

Buy-Sell FSCs. A Buy-Sell FSC acts as the direct seller of the products transferred to it by its supplier (generally the parent corporation). The supplier generally transfers the product to the FSC at a discounted price, after the stream of foreign commerce has begun. The FSC, in turn, makes the sale to the foreign purchaser. The gross receipts of both the parent and the FSC from such export sales are exempt from B&O tax, if the parent and the FSC maintain documentary proof of export. See: WAC 458-20-193C (Rule 193C) for documentary proof of export requirements.

The ETB provides a "safe harbor" of 85% for regular commission FSCs, that safe harbor is not applicable to small commission FSCs because they need not meet the same 85% test to qualify for Federal Tax benefits. Rather the ETB provides:

> Small Commission FSCs. In contrast to Regular FSCs, Small FSCs are exempt from both the foreign management and foreign economic processes requirements of the Code and need not incur substantial foreign costs to qualify for federal tax benefits. Because the 85% test does not apply to Small FSCs, a Small Commission FSC is taxable on 100% of its commission income unless it maintains records to substantiate its actual out-of-state costs of doing business.

If the taxpayer's receipts for "reimbursable" economic process costs meet the requirements as reimbursements under Rule 111, they are excludable. If they are payments for services the taxpayer performed outside of Washington, they may be excluded from the measure of tax under Rule 194. However, there is no statutory basis that allows a foreign sales corporation to exclude income for services it performs within Washington from business and occupation tax merely because it is a foreign sales corporation. Charges for administrative services between affiliated corporations have always been subject to tax. See ETB 50 and ETB 90.

ETB 558 recognizes that export sales of buy-sell FSCs are exempt. It also provides that regular commission FSCs may exclude as a safe harbor 85% of their commission receipts. This percentage reflects a test to qualify for Federal tax benefits. Under RCW 82.04.460 and Rule 194 service income for services provided both within and without this state may be apportioned on a cost basis.

It was intended that for regular commission FSCs, income from its services would approximate where the costs were incurred.

Service receipts of buy-sell FSCs were not addressed or considered in ETB 558, only sales receipts. Under that ETB, regular commission service income was multiplied by 85% to determine the amount of commission income not taxable by Washington. The department retained authority to require taxpayers to apportion this income according to their actual costs upon notification.

However, neither the commission income nor the sales income is at issue here. Rather the taxability of charges for specific services performed at specific locations is questioned. There is no authority to exempt these charges without verifying their nature, who performed them, and where they were performed. We can not blindly say that they are 100% or 85% excludable. Similarly, the 85% test is not applicable to buy-sell FSCs.

The source documents including invoices on foreign sales of related suppliers and contracts regarding these costs need to be reviewed together with information on where each entity incurred the "economic process costs." Additional records may be necessary if these receipts are from apportionable services. See WAC 458-20-194. The audit division will revise the assessment after the reimbursement entries with these documents are reviewed.

[3] Chip exchanges. In Longview Fibre Company v. Department of Rev., BTA Docket No. 12685 (December 30, 1975), The Board of Tax Appeals sustained a Department of Revenue assessment of business and occupation tax on similar wood chip exchanges. The taxpayer contends that its exchanges are distinguishable because it had no written agreement. Also the taxpayer is unaware of any situation where a cash settlement occurred. In addition, the taxpayer states that there is no "valuable consideration" present in the exchanges. Finally, the taxpayer argues that its situation is distinguishable from Time Oil v. State, 79 Wn.2d 143, 483 P.2d 628 (1971) and ETB 428.04.103.208.

We are in accord with the reasoning and outcome in Longview Fibre. The distinction of whether the contracts were written or not is not relevant. There is no dispute that these agreements controlled the transactions. Whether or not cash was ever paid is irrelevant. The chips and right to receive them constituted valuable consideration. Similarly, the distinctions between the taxpayer's situation and the facts in Time Oil and ETB 428 do not warrant a different outcome. Therefore, we sustain the audit assessment on this issue.

[4] Foreign Sales Corp profit adjustment: The profit adjustment entry at affiliate adjusts the sales prices of goods from the related supplier to the "transfer price" under the IRS guidelines for foreign sales corporations. The Audit Division accepts the

"transfer price" to be the sales price of goods sold to the Foreign Sales Corporation by affiliate. It will remove this adjustment from the assessment.

[5] Industrial claims administration. WAC 458-20-111 (Rule 111) provides for exclusion of advances and reimbursements,

> only when the customer or client alone is liable for the payment of the fees or costs and when the taxpayer making the payment has no personal liability therefor, either primarily or secondarily, other than as agent for the customer or client.

The issue is, what liability, if any, does the taxpayer have for the payments on behalf of the affiliates for their injured workers.

RCW 51.08.173 defines "self-insurer" as:

> . . . an employer or group of employers which has been authorized under this title to carry its own liability to its employees covered by this title.

WAC 296-15-022 provides in part:

> If the applicant employer is a subsidiary, the parent firm will furnish the department with its guarantee to assume and be liable for the workers' compensation liabilities of the subsidiary in the event the subsidiary firm is unable or unwilling to cover these liabilities.

WAC 296-15-023 provides:

> (1) The certification of a firm will include all of its subsidiaries or divisions doing business in the state of Washington. A subsidiary is defined, for the purpose of this rule, as an entity which is fifty percent owned and has its interest controlled by another single firm.
> (2) One certificate will be issued to an approved self-insurer, including all subsidiaries or divisions. The entities will be considered as one employer for the purposes of Title 51 RCW.

Under this scheme, it is apparent that while the employing affiliate may be primarily liable for the claims of its employees, the parent company, rather than its subsidiary is secondarily liable for the claims of employees of the other affiliates. The taxpayer is merely acting as agent of these affiliates when it processes their claims. Payments the taxpayer receives from these affiliates to pay their claims qualify for exclusion as reimbursements.

Here, the parent company is liable as the parent. The taxpayer is not liable to L&I for the claims of its affiliates' employees. The parent company receives nothing for these claims upon which tax could be imposed.

[6] Seedlings. Regarding the nature of the payments to the growers, prior to July 1, 1993, the department considered activities similar to those performed by the growers taxable under the service and other activities classification. See WAC 458-20-226 (Rule 226) which provides in part:

(d) The maintenance of lawns, plants, or gardens, including grass cutting, hedge trimming, watering, and the pruning of trees and shrubs.

> . . . Such persons are taxable under the classification service and other activities upon gross income from activities of type (d).

The growers' activities, germinating and nursing the seeds into tree seedlings, most closely resemble those in (d). The maintenance of plants including watering and the pruning of trees and shrubs is taxable under the classification service and other activities. The growers' service during the audit period was not a retail sale. This service is not a basis for imposing tax on property upon which tax has already been paid. Therefore, the taxpayer did not owe sales or use tax on the value of these services.

Provided that the taxpayer had paid retail sales tax or use tax on the seeds prior to receipt of the seedlings, no additional tax is due. However, if no tax had been paid prior to their receipt, use tax is due on the value of seedlings.

[7] Out-of-state repair. TRAMCO, Inc. v. Department of Rev., Thurston Co. Cause No. 92-2-01429-4 cited by the taxpayer involves business and occupation tax for repairs performed in Washington. The issue here is a use tax issue, specifically, are the parts incorporated into repaired equipment out-of-state includable in the measure of use tax when the equipment is returned to Washington. Use tax for out-of-state repairs is properly measured by the value of the parts installed. See Det. No. 90-298, 11 WTD 067 (1990) and ETB 421.

DECISION AND DISPOSITION:

The taxpayer's petition is granted in part. The file will be returned to the Audit Division to revise the assessment as follows:

1. We grant the taxpayer an additional thirty days to contact the auditor to provide any further evidence regarding its cash management system. If the requirements are met, this portion of the assessment will be deleted. However, if the taxpayer does not meet all of the requirements outlined above, it does not qualify for exemption, and the assessment is sustained.

2. We also grant the taxpayer thirty days from this date to contact the auditor to provide invoices for its foreign sales activities. The assessment will be reduced for those activities occurring outside Washington, as well as those for which the taxpayer was not liable other than as agent.

3. We sustain the assessment of business and occupation tax on the chip exchanges.

4. The Audit Division will delete the Foreign Sales Corp. profit adjustment from the assessments.

5. The reimbursements for employee back-pay and medical costs of other affiliates will be deleted from the administration division assessment.

6. The Audit Division will delete the use tax on the seedlings when the taxpayer paid retail sales tax or use tax on the seeds.

7. We sustain the use tax assessment for out-of-state repair.

DATED this 28th day of February, 1994.