Cite as Det. No. 95-002, 15 WTD 106 (1996)

THIS DETERMINATION HAS BEEN OVERRULED OR MODIFIED IN WHOLE OR PART BY DET. NO. 98-208, 19 WTD 332 (2000) & DET. NO. 98-187, 19 WTD 328 (2000)

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

In the Matter of the Petition for Refund of	)	D E T E R M I N A T I O N
	)	No. 95-002
. . .	)	Registration No. . . .
. . .	)	Registration No. . . .

[1] RULE 179; RCW 82.16.050(7): PUBLIC UTILITY TAX -- DEDUCTIONS -- IRRIGATION. Where a water district supplies a community with filtered, potable water and some of the water is used for watering landscaping, the deduction for water distributed through an "irrigation system, for irrigation purposes" does not apply. The term "irrigation" commonly connotes the artificial watering of agricultural lands and not landscaped grounds. A customer's addition of a separate meter and back flow device does not convert the system into an irrigation system.

[2] RULE 179; RCW 82.04.417: PUBLIC UTILITY TAX -- DEDUCTIONS -- CONTRIBUTIONS IN AID --CAPITAL FACILITIES. A P.U.D. does not satisfy the first of the three criteria set forth in Det. No. 89-451, 8 WTD 195 (1989) where there is no public identification of amounts or percentages levied for specific capital facilities expenditures. If the three criteria are otherwise satisfied, the timing of transfers into a revenue bond fund in order to satisfy other business concerns does not affect the availability of the deduction.

[3] RULE 179; RCW 82.04.417: PUBLIC UTILITY TAX -- EXEMPTION -- SERVICE CHARGES -- CONTRIBUTIONS IN AID --CAPITAL FACILITIES -- BONDED INDEBTEDNESS. The initial commingling of rate revenues with other revenues in an operating or maintenance fund does not result in a full or partial loss of the deduction so long as the source and purpose of the funds transferred into a revenue bond fund can be traced with certainty.

[4] RULE 179; RCW 82.16.050; PUBLIC UTILITY TAX -- DEDUCTIONS --

JOINTLY PROVIDED SERVICES. Where a P.U.D. purchases filtered water from another district, the P.U.D. is purchasing a commodity, filtered water, for resale and is not providing a jointly provided service, even though the other district separately itemizes the filtration costs.

[5] RULE 251: PUBLIC UTILITY TAX -- B&O TAX -- WASTE COLLECTION -- WASTE TREATMENT -- ALLOCATION. Until waste has been carried to a common point or points within a system, the activity is a collection activity for tax purposes. An engineer's analysis not based on this distinction cannot be used to allocate income between waste collection and waste treatment.

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:

Water district protests the disallowance of various refund requests. Those requests arose out of claimed deductions from income for water supplied for irrigation purposes, for costs of capital improvements, and for costs paid to another district for water filtration services. Related sewer district further protests the method used to allocate income between waste collection and waste treatment.[1]

FACTS:

Mahan, A.L.J. -- Water district and related sewer district submitted to the Department of Revenue (Department) amended excise tax returns for the 1988 through 1991 tax years and requested a tax refund. The Audit Division reviewed the taxpayers' records and certain refund requests were granted and others denied. The taxpayers then appealed.

The issues raised on appeal involve specific deductions or methods of allocation. The relevant facts with respect to each issue are as follows:

Irrigation

Certain customers of the water district have dedicated meters with back flow devices for purposes of using water supplied by the taxpayer for watering lawns and landscaping. These customers include landscape nurseries, schools, small retail businesses, and developers. They are separately charged for such water consumption apart from normal domestic water charges. Such a system also allows the customers to add fertilizers or other agents directly to the water as it is being used to water the lawns and landscaping.

The water supplied through these separate meters has been filtered and comes from the same source and through the same mains as water supplied by the taxpayer for domestic and other water uses.

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

The taxpayer does not own any part of the systems being used to water the lawns and landscaping. Currently, these customers are not charged a different rate, but the rate structure is under review.

The Audit Division did not allow the water district a deduction for water supplied through an irrigation system, for irrigation purposes, based on the holding in Det. No. 91-249R, 11 WTD 487 (1991).

Construction Fund and Revenue Bond Obligations

In 1989 the water district transferred money from its maintenance fund to its construction fund to pay part of the costs of constructing a water reservoir. According to the taxpayer, this capital facility was identified in a 1981 comprehensive plan for the district, a rate increase was authorized by a November 12, 1981 resolution by the Board of Commissioners, and specific funding was authorized as set forth in minutes dated January 12, 1989, where a bid proposal was accepted for the work. Based on documents provided by the taxpayer, the 1981 comprehensive plan "recommended" that water rates be increased to provide for various capital improvements, including the reservoir and a water filtration system. The 1981 resolution for increasing water rates, however, referred only to the water filtration system and not to other capital improvements, including the reservoir built in 1989. The bid proposal also did not identify the source of the funds to be used in the construction of the reservoir.

The Audit Division did not allow the water district a deduction for the money transferred to the construction fund, because the transfer did not meet the requirements set forth in Det. No. 89-451, 8 WTD 195 (1989).

The taxpayer also has a revenue bond fund for purposes of repaying bonds issued for capital purposes. In addition to a monthly transfer of $12,000 to the revenue bond fund, the taxpayer in 1989, 1990, and 1992 transferred $23,500, $41,818, and $9,061, respectively, from its maintenance fund.

The Audit Division disallowed the deduction for the additional transfers from the maintenance fund. Such transfers were found to have been made to avoid penalties for early withdrawal of investments that had been made with the revenue bond funds. The auditor reasoned that such transfers were not dedicated funds for a specific capital improvement.

According to the taxpayer, the additional funds were used to pay interest on the bond obligations and such transfers may allow an early satisfaction of the bond obligations. No funds transferred to the revenue bond fund are ever returned to the maintenance fund.

Reduction of Capital Deduction

The water district also protests a reduction in the amount of the deductions that were allowed on the $12,000 monthly transfers from the maintenance fund to the revenue bond fund. The auditor calculated the amount of funds received from ratepayers as a percentage of the total amount in the maintenance fund, including interest, and multiplied the amounts transferred to the revenue bond

fund by that percentage. In other words, the temporary commingling of rate income with other revenue sources in the maintenance fund resulted in a partial loss of the deduction. According to the taxpayer, the amounts transferred to the revenue bond fund never exceed the amounts received from ratepayers.

Water Filtration

The water district pays the district from which it purchases water for water filtration services. The costs for water filtration are itemized separately from the cost of the water. The taxpayer believes it should be able to deduct those charges as a service jointly provided with another district.

The taxpayer did not provide a joint agreement with the other district and does not know whether that district deducts those payments. The water district is a part-owner of the water filtration plant.

Waste Treatment/Waste Collection

The sewer district's bills do not separately itemize waste collection and waste treatment charges. As a consequence, an allocation must be made between income from waste collection (public utility tax) and income from waste treatment (service B&O tax).

The sewer district does not own its own treatment plant. Located within the district are side sewers, larger trunk lines, and lift stations. During the audit period, the sewer district had a total of thirteen lift stations in the district. The larger lift stations are located on large trunk lines. The smaller lift stations help move the waste out of the side sewers and into the main trunk lines. As the waste moves between the larger lift stations and out of the district, the pipe size increases. Waste leaves the district and moves toward treatment plants in other districts from two lift stations located within the district.

The Audit Division treated only the two lift stations where waste leaves the district as performing a treatment function. The Audit Division treated the lift stations in this manner based on **(A)**audit **(D)**directive 8251.1. It provides that, for uniformity, the "last lift station prior to a treatment plant would not be part of the collection process if no further collection lines enter the system after that point." The Audit Division then used the electricity consumption at those two plants as a percentage of the total electricity consumption in allocating costs, with the exception of actual treatment costs, between collection and treatment. Electricity was the only direct cost common to both functions.

The sewer district contends that more than two lift stations are involved in treatment. According to the district, the six larger lift stations perform the same function, that is, to move the waste between stations and out of the district. The six larger lift stations also serve a larger geographic area than the other seven stations. The sewer district contends that it is arbitrary to classify only two of the lift stations as performing a treatment function.

The taxpayer also contends that the Department should look to more than the direct costs which can be allocated, but also to the function of the pipe used. The taxpayer reasons that the length of pipe

used in each function is a better means to allocate depreciation costs. Based on this reasoning, the taxpayer distinguishes between trunk lines (treatment) and side sewers (collection) and allocates accordingly.

Using its allocation theory, the taxpayer takes the percentage of costs of the electricity used for the six larger lift stations and adds this amount to the total costs of treatment to determine a percentage of total direct costs.[2] It then multiplies this percentage by general and administrative and other expenses, except pipe depreciation. Pipe depreciation is allocated as described above. These amounts are totaled to arrive at a percentage, which is then multiplied by the total revenue amounts. As a result, the taxpayer allocates substantially more of its income to the lower tax classification.

ISSUES:

Water District:

1. Whether the taxpayer is entitled to deduct charges for separately metered water used by some of its customers allegedly for irrigation purposes.

2. Whether the taxpayer has met the requirements for deducting amounts paid by its customers for a share of the cost of capital improvements.

3. When an operating fund contains income from ratepayers and income from interest and other sources and some of the funds are transferred to a construction fund, must the deduction for amounts in aid of construction be reduced by the percentage of funds in the operating fund from nontaxable sources?

4. Whether the taxpayer jointly provided water filtration services for which it is entitled to deduct costs paid to the other joint provider.

Sewer District:

5. What factors should be taken into account in allocating income between waste treatment (service B&O) and waste collection (Public Utility Tax) when the different services are not itemized on billings to customers?

DISCUSSION:

1. Irrigation.

[1] RCW 82.16.050(7) permits a deduction from public utility tax for:

> Amounts derived from the distribution of water through an irrigation system, for irrigation purposes; . . .

[2] In response, the auditor contends that, by adding the electricity costs for the six stations to the direct treatment costs as a means to allocate other costs, the taxpayer skews the result heavily in the taxpayer's favor.

RCW 82.16.050 has remained the same for nearly sixty years, despite repeated amendments to other parts of RCW 82.16.

The Department's administrative rule implementing the statute is WAC 458-20-179 (Rule 179). Rule 179, subsection (15)(d) is virtually identical to the statute, with the notable exception of its inclusion of "solely" in limiting the availability of the deduction. It provides:

> Amounts derived from the distribution of water through an irrigation system, solely for irrigation purposes.

In Det. No. 91-249R, 11 WTD 487 (1991), we held that water distributed through a domestic water system for use by separately metered "irrigation accounts" did not qualify for the deduction. On a de novo appeal to superior court, the taxpayer was granted summary judgment. Alderwood Water Dist. v. State, No. 91-2-02722-3 (Thurston County Sup. Ct. 1993). The Department, however, is not precluded from having this issue again considered here. See, e.g., Cunningham v. State, 61 Wn. App. 562, 567, 811 P.2d 225 (1991).

To have the benefit of the deduction, the taxpayer must satisfy a two-prong test. The taxpayer must show that the water was distributed through "an irrigation system," "for irrigation purposes." Those terms are not defined by the statute. Undefined statutory terms are given their ordinary meaning. City of Seattle v. Hill, 40 Wn. App. 159, 160, 697 P.2d 596 (1985).

> Irrigation is defined as the artificial watering of agricultural lands in regions where rainfall is insufficient for crops. The ordinary and popular conception of the term is that it denotes the application of water to land for the production of crops; the term embraces all artificial watering of lands, whether by channels, by flooding, or merely by sprinkling.

45 Am. Jur. 2d, "Irrigation," § 1 at 945 (1969). The watering of lawns at a school or the watering of a parking strip by a developer does not come within the scope of what is ordinarily understood to be using water for irrigation purposes. The only customer which might be considered to be using water for irrigation purposes is the nursery.

Assuming, arguendo, that the water was being used for irrigation purposes, the evidence does not support the conclusion that the taxpayer received income from the distribution of water "through an irrigation system." Although the term "irrigation system" is not defined, the laws that existed at the time of the enactment of RCW 82.16.050, indicate that the legislature intended something more than what is advocated by the taxpayer. The laws regarding irrigation districts gave them the authority to construct and operate:

> [A] system of diverting conduits from a natural source of water supply to the point of individual distribution for irrigation purposes.

The taxpayer does not distribute water through such an irrigation system; rather, it distributes

filtered, potable water through a domestic water supply system. The addition of a separate meter by a customer does not convert a system for distributing domestic water into an irrigation system.

Under the taxpayer's rationale, if there was a means to measure the water used by a homeowner for watering his or her lawn, the taxpayer would be entitled to a deduction for that water. The deduction statute cannot be read that broadly. Exemptions to the tax law must be narrowly construed.

> Taxation is the rule and exemption is the exception. Anyone claiming a benefit or deduction from a taxable category has the burden of showing that he qualifies for it.

Budget Rent-A-Car, Inc. v. Department of Rev., 81 Wn.2d 171, 174, 500 P.2d 764 (1972). In the absence of the distribution through an irrigation system, the taxpayer is not entitled to the deduction.

2. Construction Fund and Revenue Bond Obligations.

During the periods at issue, RCW 82.04.417 provided a deduction for capital facility costs or the retirement of bond obligations for capital purposes, as follows:

> The tax imposed by chapters 82.04 and 82.16 RCW shall not apply or be deemed to apply to amounts or value paid or contributed to any county, city, town, political subdivision, or municipal or quasi municipal corporation of the state of Washington representing payments of special assessments or installments thereof and interests and penalties thereon, charges in lieu of assessments, or any other charges, payments or contributions representing a share of the cost of capital facilities constructed or to be constructed or for the retirement of obligations and payments of interest thereon issued for capital purposes.
>
> Service charges shall not be included in this exemption even though used wholly or in part for capital purposes.[3]

In order to insure that deductions are not allowed for service charges which are used for capital purposes, the Department has identified three criteria which must be satisfied:

> 1. IDENTIFICATION OF THE CUSTOMER CHARGES ATTRIBUTABLE TO CAPITAL CONSTRUCTION AND RETIREMENT OF OBLIGATIONS FOR CAPITAL PURPOSES. In order for funds received as contributions, donations, taxes, assessments, payments or other charges in lieu thereof to be tax deductible, the law requires EITHER prior ratepayer notice and acknowledgement of the necessity and amount of charges for capital facilities, improvements, or bonded indebtedness therefor, OR a county, city, town, etc. ordinance or resolution enacted in open public meeting, setting the amount, and determining necessity, which process shall be deemed equivalent to said ratepayer knowledge and approval;
>
> 2. SEGREGATION OF CAPITAL FACILITIES AND CAPITAL PURPOSE CHARGES UPON RECEIPT. Revenues derived through the duly identified and authorized methods set

[3]RCW 82.04.417 was repealed effective July 1, 1993.

> forth above must be separately accounted for and segregated into dedicated accounts, separate from other funds of the taxpayer's governing body. Commingling of such receipts may result in the loss of deductibility, for reason of uncertainty and ambiguity as to the source and purpose of the funds; and
>
> 3. DEDICATION AND ULTIMATE EXPENDITURE OF CAPITAL FACILITIES AND CAPITAL PURPOSE CHARGES FOLLOWING RECEIPT. Revenues derived through duly published and authorized methods and separated and segregated into separate accounts distinct from all other funds, must be used exclusively for the stated and approved capital facilities or improvements, or for the retirement of construction loans, bonds, or other indebtedness incurred for capital purposes. Such revenues may not be used for any other purpose.

(Emphasis in the original.)

Final Det. No. 89-451, 8 WTD 195 (1989); see also, Det. No. 87-63, 2 WTD 285 (1987).

[2] The records do not support the deduction for the funds transferred to the construction fund for the reservoir built in 1989. Although the comprehensive plan identified the reservoir as a potential project for the district, none of the records indicate that ratepayers received prior notice that specific funds were to be used for the construction. The resolution relied on by the taxpayer only identified a specific charge for the water filtration plant. Based on the record before us, we can only conclude that nondeductible service income was used for the construction.

The second issue concerns additional transfers to the bond redemption fund. Here, the Audit Division did not deny the deductions for the additional transfers into the bond fund because the payments were not authorized, segregated, and ultimately expended for a reduction of bonded indebtedness. Rather, the Audit Division was concerned with the timing of the transfers; that is, additional funds were transferred to avoid penalties on the early withdrawal of revenue bond fund investments.

In support of its contention that deductions should not be denied based on the timing of the transfers, the taxpayer cites to a May 20, 1991 letter from the Department to the taxpayers' representatives, which states in pertinent part:

> [T]ypically, all monies received are placed into a single operating account and then transferred periodically to various funds (e.g., capital construction fund, bond retirement fund, etc.). There is no specific time requirement for the amounts transferred to be deductible. However, the amounts are not deductible until such time as the monies have been transferred to the dedicated fund.

We agree. So long as the ratepayers have authorized payment of the bonded indebtedness and those funds have been segregated and dedicated to the payment of revenue bonds, we should not second guess the taxpayer's business decisions on when transfers should be made. Subject to verification

that the additional funds were identified for the retirement of obligations for capital purposes, were segregated, and were expended for bond redemption purposes, the deductions should be allowed.

3. Reduction of Capital Deduction.

[3] In the absence of specific charges on ratepayer bills and in the absence of any segregation of such charges upon receipt as specified in the second criteria set forth in Determination 89-451, 8 WTD 195 (1989), the auditor presumed the debt service amounts were partially paid out of revenues other than rate revenues. For that reason a percentage was applied to the debt service amounts which represents the percentage of rate revenue to total revenue in the maintenance fund. In other words, the temporary commingling of rate income with other revenue sources in the maintenance fund resulted in a partial loss of the deduction.

As the second criterion indicates, the commingling of funds may result in the loss of the deduction. The issue is one of tracing and certainty. As the above quote from the Department's May 20, 1991 letter recognizes, funds received by a water district are typically placed into an operating fund with other funds until transferred to various other funds. In and of itself, the initial commingling of funds does not result in the loss of the deduction. So long as the funds authorized and identified for payment of bonded debt obligations are traceable as solely coming from dedicated funds, the deduction should remain intact regardless of the temporary commingling with other assets. To the extent the taxpayer can demonstrate to the Audit Division that the funds can be traced with certainty to dedicated funds, no percentage loss of the deduction should occur.

4. Water Filtration.

[4] RCW 82.16.050, in relevant part provides:

> In computing tax there may be deducted from the gross income the following items:
>
> . . .
>
> (2) Amounts derived from the sale of commodities to persons in the same public service business as the seller, for resale as such within this state. This deduction is allowed only with respect to water distribution, light and power, gas distribution or other public service businesses which furnish water, electrical energy, gas or any other commodity in the performance of public service businesses;
>
> (3) Amounts actually paid by a taxpayer to another person taxable under this chapter as the latter's portion of the consideration due for services furnished jointly by both, if the total amount has been credited to and appears in the gross income reported for tax by the former; . . .

WAC 458-20-179 (Rule 179), subsection (15) provides for a deduction for amounts derived from the following:

> . . .
>
> (b) Amounts derived by persons engaged in the water distribution, or gas distribution business, from the sale of commodities to persons in the same public service business for resale as such within this state.
>
> (c) Amounts actually paid by a taxpayer to another person taxable under chapter 82.16 RCW as the latter's portion of the consideration due for services jointly furnished by both.

The intent of these provisions is to limit the multiple imposition of the public utility tax on commodities for resale and for jointly provided services. See PUD No. 2 of Grant Cty. v. State, 82 Wn.2d 232, 242, 510 P.2d 206 (1973).

Although the district from which the taxpayer purchases water provides a breakdown on its invoices for the cost of water and filtration, this does not mean that it is selling services separate and apart from the commodity it is selling, that is, filtered water. Nor is there any support for the proposition that the taxpayer is providing a filtration service jointly with the district selling it filtered water. The taxpayer has not provided any agreement for the sharing of income or expenses for a service jointly provided to ratepayers. To the contrary, the invoices demonstrate that the taxpayer is merely purchasing water which has been filtered by the district selling it the water. Further, there is no evidence that the public utility tax will be imposed more than once.

5. Waste Treatment/Waste Collection

[5] The taxpayer's sewage collection business is subject to public utility tax, whereas its income from the "transfer, treatment or disposal" of sewage is subject to service B&O tax. WAC 458-20-251 (Rule 251). If a taxpayer does not separately itemize on customer billings the specific charge for collection services, then the taxpayer must use a cost-of-doing-business formula to ascertain the proper allocation of receipts between those taxable under the public utility tax and those taxable under the B&O tax. Rule 251(6)(b).

The sewage district seeks to allocate its income based on an analysis by its engineer of the district's lift stations and the piping related to those lift stations. The taxpayer reasons that, because its larger lift stations perform the same function as the two lift stations used by the auditor in allocating income, the larger lift stations and pipe associated therewith should also be used to allocate income. The problem with this analysis is that the opposite is equally true, that is, none of the lift stations should be used to allocate income.

Although we have recognized that an engineer's analysis may be helpful in allocating income, the analysis must conform with the requirements of Rule 251. Det. No. 88-22, 5 WTD 53 (1988). The analysis proposed by the taxpayer does not conform with the Rule. Rule 251 defines the term "sewage collection business" to mean:

> the activity of receiving sewage deposited into and carried off by a system of sewers, drains,

> and pipes to a common point, or points, for disposal or for transfer to treatment for disposal, but does not include such transfer, treatment, or disposal of sewage.

Rule 251(3)(a). Under the Rule, until sewage is carried to a common point or points, the process involves a sewage collection activity. Nothing in the engineer's analysis demonstrates that the district's sewage had been carried to a common point or points until it reached the two lift stations identified by the auditor. The district's sewer map further indicates that, prior to the final two lift stations, sewage continued to be collected and added to the flow of sewage leaving the district.

DECISION AND DISPOSITION:

The petitions are granted in part and denied in part. We affirm the disallowance of deductions for the amounts transferred for the construction of the reservoir, for claimed irrigation purposes, and for claimed jointly provided water filtration. We also affirm the Audit Division's sewer collection classification. Subject to verification by the Audit Division, the deductions for funds transferred to the bond redemption fund are allowed in full. This matter will be remanded to the Audit Division for verification.

DATED this 19th day of January, 1995