

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment)	
)	No. 97-178
)	
...)	Registration No. . . .
)	FY. . . /Audit No. . . .
)	

- [1] RCW 82.04.080: B&O TAX -- GROSS INCOME OF THE BUSINESS. Generally, the measure of the business and occupation includes interest, dividends, and gains on the sale of investments.
- [2] RCW 82.04.4281; ETB 571: B&O TAX -- OTHER FINANCIAL BUSINESS. Persons, other than banks, loan businesses, security businesses, and “other financial businesses”, are allowed a deduction for interest, dividends, and gain on sale of investments. The determination whether a business is an “other financial business” is made by applying the test stated in Excise Tax Bulletin 571.
- [3] RCW 82.04.4281; ETB 571: B&O TAX -- OTHER FINANCIAL BUSINESS. A person is engaged in an “other financial business” if the business is similar or comparable to a banking, loan, or security business.
- [4] RCW 82.04.4281; ETB 571: B&O TAX -- OTHER FINANCIAL BUSINESS. Where (1) a taxpayer’s financial income and securities business-like fees constitute over 87% of its gross income; (2) the taxpayer is involved in regular and recurrent trading; and (3) the taxpayer has no business purpose other than the investment of money, the taxpayer is similar or comparable to a securities business and the RCW 82.04.4281 deduction is not available to it.

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:

A family-owned investment company, a corporation, protests the Department of Revenue's finding that it is engaged in a financial business.¹

FACTS:

Coffman, A.L.J. -- The taxpayer is a Washington corporation. The Department of Revenue's (Department) Audit Division reviewed the taxpayer's books and records for the period January 1, 1992 through December 31, 1995. As a result of that review, the Audit Division found that the taxpayer had underpaid its excise tax obligations by failing to report its receipt of interest, dividends, and gains on the sale of securities. Additionally, the taxpayer reported its receipt of management fees, U.S. Treasury bill set-up fees, and computer fees under the services and other activities business and occupation (B&O) tax classification instead of the new selected business services classification² for the period July 1, 1993 through December 31, 1995, and, also, under reported its use tax liability. The taxpayer is not protesting the assessment of selected business services B&O tax or use tax.

The corporate taxpayer was formed by members of a single extended family for the purpose of combining assets and investing those assets. The shareholders of the taxpayer are five individuals, four trusts (two are testamentary trusts and two are grantor trusts, the beneficiaries of which are related to the individual shareholders), and one limited partnership whose partners are the same five individuals. All the investments are owned by the taxpayer. There is no evidence that the investments are held in trust for particular shareholders or otherwise designated as a shareholder's investment.

...

The taxpayer invests primarily in banks or thrift institutions and natural resources companies. Additional investments were made in companies involved in drugs and health supplies, energy, fertilizers, manufacturing, software, and transportation. The investments were generally long term in nature. During the four-year Audit Period, the taxpayer held 42 different investments. The taxpayer held an average of 27.5 investments per year. Its portfolio of investments had a value of between \$1,823,000 and \$2,487,000 during the audit period.

The taxpayer liquidated investments in each year

The taxpayer claims it holds investments for potential long term return. Thus, the taxpayer identified the holding periods of liquidated investments in terms of years.

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

² Effective July 1, 1998, the selected business services B&O tax classification will be repealed.

The taxpayer claims it was audited by the Department in 1973 and, as a result of that audit, it was informed that its financial income was deductible. The taxpayer does not have a copy of the audit report. Our review of the Department's records did not disclose any written instructions relating to that audit.³

The taxpayer charged management fees to its shareholders/clients. The management fees were for bookkeeping, accounting, tax, and investment services. Additionally, the taxpayer charged its shareholders/clients, computer fees and Treasury bill (T-Bill) set-up fees. The taxpayer explains that I.R.C. § 482 requires it to charge these fees.

ISSUE:

Is taxpayer's receipt of financial income deductible from the measure of the B&O tax under RCW 82.04.4281?

DISCUSSION:

[1] The B&O tax is imposed on the privilege of doing business in this state. RCW 82.04.220. The measure of the B&O tax for the activities of the taxpayer is the gross income of the business which is defined in RCW 82.04.080 as:

. . . 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.

Thus, taxpayer's receipt of interest, dividends, and gains on the sale of investments are generally taxable. However, RCW 82.04.4281 states that:

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 .

[2] The taxpayer argues that it is not a financial business and therefore it is entitled to the RCW 82.04.4281 deduction. The courts have issued several decisions concerning this

³ We were able to retrieve a copy of the post assessment adjustment for the 1973 audit. Although, most of the copy was unreadable, we have determined that the adjustment related solely to use tax liability.

deduction.⁴ The Department in Det. No. 93-269ER, 14 WTD 153 (1994) summarized the court cases and the Department's prior rulings and specified the test for this deduction. The test was further clarified in Excise Tax Bulletin 571.04.146/109 (ETB 571) which states:

A two part inquiry is used to determine if the taxpayer is a "banking, loan, security, or other financial business". The first inquiry requires determining whether the primary purpose and objective of the taxpayer is to earn income through the utilization of significant cash outlays or whether these activities are merely "incidental" to the taxpayer's nonfinancial business activities. This inquiry is made by applying a percentage test. The Department conclusively presumes that the income is not from engaging in a financial business, but is incidental to the nonfinancial business activities, if the financial income is five percent or less of the annual gross receipts. The percentage of financial income will be computed by including all calendar or fiscal year financial income from "loans and investments or the use of money as such" in the numerator, whether taxable, exempt, or deductible, and including all calendar or fiscal year revenues as normally measured by the B&O tax, including all revenues otherwise exempt or deductible, in the denominator.

If the first inquiry results in five percent or less of financial income in each of the years, it is unnecessary to proceed to the second inquiry. The taxpayer will not be considered as engaging in a "financial business". If the percentage exceeds five percent in any of the years, it is necessary to proceed with the second inquiry, but only for those years in which the percentage exceeds five percent.

[3] "It is undisputed that [taxpayer] meets the 5% test of the first inquiry." Taxpayer's petition, page 3. Thus, we need only address the second inquiry under ETB 571. That is -- Is the taxpayer similar or comparable to banking, loan, or securities businesses? ETB 571 states:

The second inquiry for determining when a taxpayer's activities constitute a "financial business" involves whether the taxpayer's activities are similar to, or comparable to, those of "banking, loan, [or] security businesses", even though the taxpayer might not technically fall within one of those three categories. The factors which will be considered include, but are not limited to, the source of the income, frequency of investments, volume of investments, percentage of income from investments in relation to the total income of the business, and the relationship of the investment income to the other activities of the business.

For a business activity to be considered "similar" and "comparable" to "banking, loan, [or] security" businesses, the activity must be regular and recurrent. Indicia of regular and recurrent activities "similar or comparable" to those of a "banking, loan [or] security business" include, but are not limited to: (1) For a bank and loan business: the making of loans on a continuing basis. (2) For a securities business: (a) a diversified portfolio, (b) a

⁴ See, e.g., John H. Sellen Constr. Co. v. Department of Rev., 87 Wn.2d 878, 558 P.2d 1342 (1976); Rainier Bancorporation v. Department of Rev., 96 Wn.2d 669, 638 P.2d 575 (1982); and O'Leary v. Department of Rev., 105 Wn.2d 679, 717 P.2d 273 (1986).

need for expertise, whether from an internal or external source, in the selection and management of investments; and (c) trading activities.

(Emphasis added.) Although the taxpayer received significant interest income during the audit period, the taxpayer did not, in the traditional sense, loan money on a continuing basis. That is -- The taxpayer did not loan money directly to corporations and individuals and receive notes payable with security interests in property owned by the borrower. Rather, the taxpayer's interest income was derived primarily from corporate bonds and other interest paying securities. Therefore, we must determine if the taxpayer's business was similar or comparable to a securities business.

The taxpayer argues that it is not similar or comparable to a security business because it is not licensed as a securities broker or dealer. We note that if the taxpayer was licensed as a securities broker or dealer, then it would be operating a securities business and we would not have to determine if it was similar or comparable to one.

[4] The taxpayer charges its shareholders/clients management fees and set-up fees. These are the fees that frequently are charged to customers of security houses. The taxpayer makes investments on behalf of its shareholders. This is also a service provided by security businesses.

The taxpayer argues that the lack of diversification in the investments shows it is not comparable to a securities business. Specifically, the taxpayer states that 80% of its securities are invested in either banking or natural resources businesses. The taxpayer claims that such holdings clearly demonstrate that the investments are not diversified. However, there are many securities funds that invest in particular types of businesses.

The fact that the shareholders/clients choose to invest in limited industries does not control our determination. The diversification referred to in ETB 571 can be within industries. The fact is that the taxpayer held an average of 27.5 different investments every year. The average value of each of those investments is approximately \$75,000.⁵ Therefore, we find that the taxpayer's investments are diversified.

The taxpayer alleges that it does not have the expertise to make investment decisions. However, the taxpayer makes investment decisions based on directions from its shareholders/clients. Further, the taxpayer charges its shareholder/clients management fees for services provided. The taxpayer had three full-time and four part-time employees during the audit period. The taxpayer claims that the employees did not perform significant services. However, the number of employees is reflective of the level of investment activity.

During the Audit period, the portfolio of investments included 42 different investments. The average number of investments per year was 27.5. The taxpayer made an average of 5.5 voluntary sales of securities per year during the audit period. Thus, the taxpayer liquidated all or

⁵ The average value of the portfolio was \$2,070,000 divided by 27.5 equals \$75,272.

part of 20% of its investments every year. If the involuntary sales are considered, the average number of transactions was 8.75 per year or approximately 30% of the investments were liquidated per year. The taxpayer argues that the number of trades is low. This is true in raw numbers, but not in respect to the number of investments. Thus, we find that the taxpayer's trading activities are regular and recurring.

When considering the value of the portfolio, we note that the taxpayer liquidated, on average, approximately 17.5% of the portfolio value each year. We note that the financial income generated by the taxpayer was 55% of its total income. Further, the management fees and T-bill setup fees are similar to fees charged by securities business. If we treat these fees as security business income, we find that the total financial/securities business income is approximately 87% of the total income.

The taxpayer has not disclosed any business activity other than its investments on behalf of its shareholder/clients and the charging of fees relating to that activity. Thus, the taxpayer's sole reason for existence is the investment of money in securities.

Finally, the taxpayer argues that it only represents the interests of its shareholders/clients and concludes that, therefore, it can not be a financial business. The issue is not whether the taxpayer is in competition with securities business, but whether it is similar or comparable. We find that the taxpayer is similar and comparable to a securities business and therefore is an "other financial business". Thus, it is not entitled to the benefit of the RCW 82.04.4281 deduction.

DECISION AND DISPOSITION:

Taxpayer's petition is denied.

Dated this 29th day of August, 1997.