Cite as 2WTD 109 (1986)

BEFORE THE DIRECTOR
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessments of	)	F I N A L D E T E R M I N A T I O N
	)	No. 85-117B
. . . BANK	)	Registration No. . . .
	)	Tax Assessment No. . . .
and	)	
. . . LEASING CORPORATION	)	Registration No. . . .
	)	Tax Assessment No. . . .

[1] RULE 196 and RCW 82.08.100 - RULE 199: SALES TAX -- BAD DEBTS -- LEASE ACCRUALS BEFORE REPOSSESSION -- ACCRUAL v. CASH BASIS ACCOUNTING. Automobile lease payment deficiencies, accrued and booked as income on the accrual basis, were subject to retail sales tax for periods before January 1, 1983 (RCW 82.08.100), the bad debt deduction for sales tax, even though approved for payment to the state on the cash receipts basis.

[2] RULE 109 - RULE 146 and RCW 82.04.315: B&O TAX -- SERVICE -- INTERNATIONAL BANKING FACILITIES (IBF's) -- INTEREST ACCRUAL TRANSFERS. Interest income accrued and accounted for by a bank before it creates a tax exempt IBF account is not tax exempt under RCW 82.04.315, even though transferred into the IBF account when cash received.

[3] RULE 146 - 31 U.S.C. 3124(a): B&O TAX -- SERVICE -- REVERSE REPOS. Interest income derived from reverse repurchase agreements is subject to Service B&O tax and is not within the scope of any state statutory tax Exemption nor prohibited from state taxation under federal law, 31 U.S.C.3124(a).

[4] RULE 146 - RULE 109 and RCW 82.04.4293: B&O TAX -- SERVICE -- DEDUCTION -- INTEREST -- PRESERVATION AND DEVELOPMENT AUTHORITIES LOANS. Interest income derived from loans to PDAs created by cities is not entitled to B&O tax deduction under RCW 82.04.4293 (see Determination 85-117 for substantive treatment of merits).

[5] RULE 146 - RULE 162: B&O TAX -- SERVICE -- EXEMPTION -- 31 U.S.C. 3124(a) -- SECURITIES TRADING -- TAXABLE GAINS.
Because the Service B&O tax measured by gains from trading in U.S. Government securities does not require a consideration of the government obligation or interest thereon, such amounts are not protected from state B&O taxation under 31 U.S.C. 3124(a).

[6] RULE 146: BANKS -- B&O TAX -- SERVICE -- FUTURES CONTRACTS -- INTEREST RATE SWAPS.
Amounts derived from banking transactions designated as futures contracts and interest rate swaps constitute business taxable "gross receipts," regardless of their purpose of hedging against risk. (See Determination 85-117 for substantive 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.

TAXPAYER REPRESENTED BY: . . .
. . .

HEARING CONDUCTED BY DIRECTOR'S DESIGNEES:

Gary O'Neil, Assistant Director
Garry G. Fujita, Chief of Interpretation and Appeals
Edward L. Faker, Senior Administration Law Judge

DATE OF HEARING: July 31, 1986

NATURE OF ACTION:

The taxpayers have appealed to the Acting Director from certain findings and conclusions of Determination No. 85-117 which was issued on June 7, 1985 pursuant to an original appeal hearing conducted in Seattle, Washington on January 15, 1985. That Determination sustained the assessment of retail sales tax as well as business and occupation tax under the Service classification upon amounts derived from the taxpayer's various financial transactions.

Retail sales tax was assessed and sustained upon defaulted and uncollected auto lease income for the audit periods prior to January 1, 1983. . . . Bank (. . .) and . . .Leasing Corporation were both assessed for tax upon such transactions.

Service business tax was assessed and sustained upon interest derived or gains realized from various [bank] financial business transactions, as specifically itemized later herein.

FACTS AND ISSUES:

Faker, Sr. A.L.J. -- The facts of this case are not in dispute. They are fully and properly set forth, together with the audit and tax assessment details, in Determination No. 85-177 and will not be restated here.

There are six issues on appeal to the Director. Numerous other issues were resolved through Determination 85-177 and have not been further appealed.

Issue No. 1

Before January 1, 1983 (the effective date of law allowing bad debt deductions for retail sales tax) were automobile lease payment deficiencies, which were accrued and looked as income, subject to retail sales tax even though written off as bad debts after actual repossession?

Issue No. 2

Is interest income, accrued by a bank before its creation of an International Banking Facility (IBF) under RCW 82.04.315, and paid over to the IBF after its creation on a cash receipts basis, entitled to tax exemption under the statute?

Issue No. 3

Are amounts derived as "interest" by financial businesses from "reverse repurchase" transactions entitled to tax exemption under RCW 82.04.4292 (loans secured by first mortgages) or under 31 U.S.C. 5 3124(a) (trading in U.S. Government securities)?

Issue No. 4

Are amounts derived as interest on loans, to Preservation and Development Authorities created by cities, entitled to tax exemption under RCW 82.04.4293 (interest on obligations of the state and municipal corporations organized under state law)?

Issued No. 5

Are gains realized from trading (buying and selling) U.S. Government securities exempt of state business tax under 31 U.S.C. 5 3124(a), because the gain is determined based upon considerations of the value of the obligation and the interest thereon, directly or indirectly?

Issue No. 6

Do financial deals referred to as "futures contracts" and "interest rate swaps," transacted in order to hedge against future interest rate fluctuations, derive taxable interest income?

TAXPAYERS' EXCEPTIONS:

Issue No. 1

The taxpayer, Leasing Corporation, asserts that the Department has approved and allowed it to report tax upon income from automobile leases on a cash receipts basis. However, when leases were sometimes defaulted because of nonpayment, there were periods of three months' duration between the actual first defaulted payment date and the physical repossession of the vehicle or other recovery action. During that interim period the periodic lease payments were recorded on the taxpayer's accounting records, though they were never actually received. At the time of the ultimated repossession or other legal remedy,the taxpayer adjusted its accounting records to reflect the three months' lease accruals as defaulted amounts or bad debts. Nonetheless, the taxpayer asserts, the Department has subjected this imputed income to retail sales tax liability and assessed this tax from the dates the defaulted, unpaid payments fell due under the leases.

The taxpayer asserts that its policy is to allow the period of three months between default and actual repossession or collection proceedings, but that legally the leases expressly provide for default as of the very first failure to timely pay the lease payment. The taxpayer argues that the rule expressed in WAC 458-20-197, that "liability for retail sales tax arises as of the time the rental payments fall due," is not appropriate for application in this case. Again, this is because the Department has allowed cash receipts reporting rather than the accrual method by these taxpayers. The taxpayers challenge the reasoning in Determination 85-177 that the substantive liability for retail sales tax arose when the lease payments fell due, even though the Department may have allowed for deferral of payment of this tax until the lease income was received. The taxpayers simply seek to be treated as "cash basis" taxpayers rather than "accrual basis" taxpayers so as to avoid sales tax liability upon amounts never actually received.

Issue No. 2

On September 1, 1982 the taxpayer, Bank, created an International Banking Facility (IBF) to encourage export trade, under federal guidelines. Certain receivables, including accrued interest, were entitled to be transferred to the IBF within a window period of 60 days after its creation. Under the provisions of RCW 82.04.315 the business and occupation tax does not apply to gross receipts of an international banking facility. The taxpayer asserts that interest income accrued upon loans by the Bank is entitled to the exemption if it is timely transferred to the IBF.
The taxpayer's petition to the Director includes the following:

> . . . The Bank on September 1, 1982 created an IBF and transferred certain receivables, including accrued

> interest, to the IBF. The interest on the receivables had accrued prior to the effective date of RCW 82.04.315. The auditor assessed B & O tax on cash received by the IBF with respect to the interest accrued prior to the transfer date. This determination flies in the face of RCW 82.04.315 which plainly provides that all gross receipts of an IBF are not subject to the tax. We noted in our argument that the Department had previously determined that [bank] has the right to utilize the cash basis in reporting its Washington state excise tax liability. Determination No. 73-130. Since [bank] is legitimately on the cash basis, the interest receivable by [bank] or its IBF should be taxed only as received. The interest was received in the hands of the IBF and therefore under RCW 82.04.315 must be exempt. The Administrative Law Judge determined that [bank] is required to pay its business and occupation tax on an accrual basis; the receivables having accrued in the hands of . . . Bank must be taxable there rather than through the IBF. The ALJ also determined that RCW 82.04.315 should not be interpreted to permit the transfer of taxable items to an IBF simply for tax avoidance purposes. The Determination with respect to placing . . . Bank on the accrual basis flies in the face of Determination 73-130. There is no proof or suggestion in the file whatsoever that [bank] transferred the receivables for tax-avoidance purposes. Any conclusion or suggestion reached by the Administrative Law Judge is without factual basis. For these reasons we believe that the determination of ALJ should be reversed.

The taxpayer asserts that, because the interest was booked to the IBF account when it was actually received it should be entitled to the plenary tax exemption, notwithstanding that it was accrued by the Bank before the IBF was created.

Issue No. 3

The taxpayer asserts that "reverse repo" transactions are not loans, as concluded in Determination No. 85-177. Rather, these transactions have all of the attributes of true "sales" as defined by RCW 82.04.040, because the Bank obtained ownership of , title to, and possession of securities in exchange for valuable consideration. The taxpayer cites the decision in Inland Empire Dairy Association v. Department of Revenue, 14 Wn.App. 592 (1975) for the proposition that its reverse repurchase transactions are outright purchases and sales back.

The taxpayer's petition includes the following:

> [Bank] argued that it was entitled to deduct interest received on United States Government securities purchased

> pursuant to a reverse repurchase transaction (reverse repo). The facts of the circumstance are well set out in our initial petition to the Department of Revenue. We argued clearly based on federal court cases, expert testimony and submission of regulatory agency rules that a reverse repo is in fact a purchase of United States Government securities by an institution and not in fact a secured loan. The Administrative Law Judge found an article in the Wall Street Journal and based his determination on that article. The ALJ simply ignored the evidence that was presented at the hearing and made his determination without permitting the taxpayer to refute the extraneous evidence recognized by him. The vast weight of evidence on the point argues strongly that a reverse repo is in fact a purchase of government securities by [bank] and not a loan transaction. Consequently the determination of the ALJ should be reversed.

The taxpayer asserts that because these transactions are outright purchases and sales of government securities rather than secured loans, therefore federal law, 31 U.S.C. 5 3124, prohibits state taxation upon gains from trading or buying and selling such securities. The taxpayer's arguments on the issue are detailed under Issue No. 5 below, in connection with other government securities traded.

Issue No. 4

The taxpayer asserts that the Pike Place Market Preservation and Development Authority and the Seattle China Town-International District Preservation and Development Authority are "municipal corporations" within the contemplation of RCW 82.04.293. Thus, under that law, interest income derived by the Bank from loans to these entities is entitled to business tax deduction as "interest paid on all obligations of the state of Washington, its political subdivisions, and municipal corporations organized pursuant to the laws thereof." (Emphasis supplied.)

The Preservation and Development Authorities (PDAs) in question borrowed money from the bank and paid interest on these loans. However, Determination No. 85-117 concluded that the statutory inclusion of "municipal corporations" was limited, in the strictest sense to "cities" themselves and not the broader classification of quasi-municipal corporations which cities may create.

The taxpayer emphasizes that the PDAs are treated in all respects as municipal corporations and are clothed with all the attributes thereof, including exemption from property taxation. If not considered to be separate municipal corporations, these entities are simply a part of the City of Seattle itself, according to the taxpayer. However they may be designated, the taxpayer argues

these entities loan securities constitute municipal obligations the interest from which is tax deductible under the statute.

Moreover, the taxpayer contends that PDAs have been treated as "political subdivisions" of the state for other business tax exemption purposes. The taxpayer reiterated the arguments set forth in the Taxpayers' Exceptions portion of Determination 85-117, and again relied upon the exhibits reflecting prior rulings of the Department concerning the tax deduction treatment. The taxpayers' petition to the Director includes the following:

> . . . Our arguments were convincingly set out in our appeal. Each PDA was created as a municipal corporation by the State Legislature. Each PDA has been granted sovereign powers by the Legislature. Further, the obligations were issued "by or on behalf of" the City of Seattle, and thus the PDA is vested with the authority for the City of Seattle in connection with its issuance of the obligations. We made a number of that each PDA is a municipal corporation; each was rationalized away by the Administrative Law Judge. The clear weight of the arguments and the conclusion which must be drawn from the overall reading of the statute is that each PDA is a municipal corporation for purposes of RCW 82.04.4293. The conclusion of the ALJ with Respect to this issue should be overturned.

Issue No. 5

The taxpayer asserts that any tax upon gains realized from trading (buying and selling) U.S. Government securities is in violation of the U.S. Code prohibition at 31 U.S.C. 5 3124(a). It paid Service business tax measured by such gains and it seeks a refund. The taxpayer challenges the reasoning of Determination 85-117 that the tax is not computed based upon any consideration of the value of the securities and their interest yields, but merely upon the gross purchase prices and gross selling prices of the securities in the financial marketplace. The Determination's rationale is that the purchase and selling prices of the securities are driven by considerations other than the worth of the securities or whether they even bear interest. In other words, the securities may be worth more or less than the purchase and sales prices and may of may not bear interest. Rather, the amounts derived from trading in these securities turns upon liquidity needs and other factors separate and apart from their intrinsic, maturity value. The taxpayer disagrees. It insists that the gains or losses realized from trading are based upon the value of the securities principle and whatever rate of interest or discount they carry. The taxpayer asserts that such securities are always measured on a discount-interest basis, not on a capital gains basis. In other words the selling/purchase price computations are always based upon the current discount interest rate and all income is current market

rate driven. It speaks for itself that the interest rates are a consideration in deciding when to sell these securities and at what price. Thus, at least indirectly, a tax upon gains realized from buying and selling such securities requires the consideration of the value of the obligations or interest thereon, or both, in violation of the federal law prohibition.

The taxpayer expounded upon its position that the tax in question here indirectly impairs the government from borrowing money. If such transactions as selling the government from obligated securities are taxable, then the financier would require a higher rate of return because subsequent sales prices will have to include costs such as business and occupation taxes on the proceeds of the sale.

The taxpayers' petition to the Director includes the following:

> . . . 31 U.S.C. 5 3124 prohibits the assessment of state taxes on gains recognized by [bank] from trading in U.S. Government securities. This statute is clear and the case law indicates unequivocally that state and local governments are prohibited from taxing any portion of income received on United States Government obligations. The federal exemption statute "extends to every form of taxation that would require either the obligations or the interest thereon, or both, to be considered, directly or indirectly, in the computation of the tax." A tax on gain on U.S. Government Securities requires that both the obligations and the interest thereon be "considered" in computing Washington's B & O tax. An interpretation of Washington law that permits taxation of these gains in contrary to the federal statute. The ALJ rationalizes that neither the obligation nor its interest are "considered" in computing the tax. In fact, the obligation and its interest are the sole components of the gains which [bank] realizes with respect to its trading in Government securities. The statute does not require that the U.S. Government pay the gains or the interest; it requires only that the obligations be "considered" in the measure of the tax. Case law referred to in our petition makes clear that any degree of relationship between the bonds and the tax will render the tax inapplicable. The determination of the ALJ should be reversed in this respect.

The case law referred to is cited in Determination 85-117.

These same arguments are proffered with respect to the reverse repo transactions discussed earlier under Issue No. 3. If those transactions are not secured loans, then they are outright security sales, the gains from which are protected from state taxation under the federal law.

Issue No. 6

The taxpayer reported and paid Service business tax upon gross receipts from futures contracts and interest rate swaps. The Department's auditors adjusted this reporting to allow for losses realized on these transactions but denied tax relief on net gains. The taxpayer, on appeal, asserted that these transactions incur no tax liability at all because they derive no real income, but merely reduce expenses by hedging against interest rate risks and exposure. The transactions in question are explained in Determination 85-117 in greater detail.

At the July 31, 1986 hearing the taxpayers' Assistant Vice President testified that these financial ventures are structured to hedge liabilities, not assets. They are intended to reduce losses which occur when interest rates, driven by financial marketplace variables, fluctuate up or down. Their purpose is not income producing. Also under federal banking regulatory principles these transactions are accounted for and booked as expense reductions, not gains. As to interest rate swaps, it was testified that the result is simply a "wash." Banks exchange debts at different outstanding interest rates and no income is actually derived by anyone.

An exemplary transaction would be the taxpayer borrowing currently at seven percent interest on its obligation and protecting that rate by securing a right to borrow at six percent interest. If the taxpayer has no need for the six percent rate guarantee, it sells it to another borrower at a premium. In that case the premium is the gain which the auditors held to be taxable, after offsetting losses. Determination 85-117 did not disturb the auditors' conclusions, but opined that these transactions may not constitute trading in evidences of indebtedness under RCW 82.04.080, taxable only on the gains realized, but merely constituted financial business taxable on "gross income" without any deduction for losses, under RCW 82.04.080.

The taxpayer explained that interest rate are swapped to attempt to achieve parity between liabilities and assets. Interest earning capacities are simply traded on outstanding obligations, with each party assuming the other's obligation. By this mechanism, a bank with adjustable rate assets might acquire adjustable rated interest on other obligations. In reality, there may be a marginal difference when market rates fluctuate. This difference has been taxed as "gains." The taxpayer analogized its swaps with trades of vehicles which had balances owing on their purchase prices and concluded that the assumed obligations for payment of those balances would not constitute income to the trading parties.

DISCUSSION:

Issue No. 1

[1] Our review of the taxpayers' petitions, testimony and of Determination 85-117 reveals that the Determination properly resolves this issue. The controlling conclusion is that the taxpayer, Leasing Company, is not a "cash receipts basis" taxpayer as claimed. This taxpayer regularly maintained its vehicle lease books and records on an accrual basis during the period in question. It was simply allowed to report and pay its retail sales tax liability when the lease income was actually received. Such payment deferral, acquiesced in by the Department for the taxpayers' convenience, did not obviate the taxpayers' statutory obligation for actual collection and payment of the tax on accrued lease amounts. That liability was overcome only on January 1, 1983 when the statutory law was effectively amended to allow retail sales tax deductions for bad debts. Determination 85-117 fully and properly explains this position under the law and in application of WAC 458-20-199 (Accounting Methods). We hereby sustain the findings and conclusions of the Determination on this point.

Also of importance is the fact that the taxpayer did not terminate its lease agreements with vehicle lessees until three months after default in lease payments. The taxpayers' own petition and testimony reveal that, "(a)fter default and termination, no more lease payments come due, and once the leased property is repossessed, the lessee ceases to be liable for future monthly payments." Clearly, during the three-month interim period between default and repossession, the lessee is fully liable for payment and retail sales tax is due upon such amounts, accrued or received, until the law changed effective January 1, 1983.

Conclusion

Automobile lease payment deficiencies, accrued and booked as income, were subject to retail sales tax by the lessor for all periods before January 1, 1983, notwithstanding that the lessor's reporting and payment of the tax to the state for deferral until lease payments were received.

Issue No. 2

[2] For the same reasons stated earlier regarding Issue No. 1. and for the reasons succinctly expressed in Determination 85-117, we find that the provisions of RCW 82.04.315 do not apply for interest income accrued by the taxpayer and paid into its IBF when received. Again, the taxpayer is an accrual basis taxpayer by definition, notwithstanding that its tax reporting and payment obligation was deferred until actual receipt of the interest income. Moreover, the interest income in question was earned and accrued by the taxpayer, Bank, before it created its IBF. We find, in support of the conclusions of Determination 85-117, that the interest income in question constituted part of the gross income of the Bank, not

its IBF. Even if these amounts could be said to satisfy the definition of "gross receipts" of the IBF, under RCW 82.04.315, when actually transferred into that account, no tax was assessed against the IBF at that time. Clearly, the statute did not create a plenary, retroactive tax exemption for all amounts earned and taxable before the creation of the IBF, simply because such amounts may be subsequently transferred to the IBF account. In this respect, it is not the Department's position or the crux of the Determination ruling that the taxpayer entertained any illegitimate tax "avoidance" scheme. In the generic sense, any tax exemption or deduction results in tax payment being avoided. However, such legal tax avoidance is clearly contemplated under appropriate statutory law. In this case, however, the tax avoidance provided for by RCW 82.04.315 is not available.

Conclusion

Interest income accrued and accounted for by the bank before its establishment of a tax exempt IBF account is not entitled to business tax exemption under RCW 82.04.315 simply because it is subsequently paid into the IBF when actually received.

Issue No. 3

[3] The taxpayers' explanations of repurchase and reverse repurchase transactions, though enlightening, leave considerable doubt as to the precise nature of these financial undertakings. The record of this case and the Department's further inquiries reveal that these transactions can be treated in various ways for federal taxation and banking regulatory purposes. They are sometimes treated as loans and sometimes as agreements involving sales of assets of "financing transaction" (i.e., as borrowings secured by the assets sold). Moreover, this confusion is magnified by the fact that these financial undertakings, in current banking practices, are electronically transacted without security certificates being issued or transferred, and with only memoranda evidence of ownership of the underlying securities. When actual certificates are involved in reverse repo arrangements, they are often retained by the seller and possession does not transfer. Usually the interest obligation of the federal government on these securities flows directly and exclusively to the registered owner which ownership does not change throughout the reverse repurchase period. The so-called "repurchase" price may be calculated based upon the going market rate of interest or the rate payable on the underlying security if the market rate is higher. In short, reverse repurchase transactions can be so obscure and complex that even the taxpayer is unable to fully explain them with assurance. Determination 85-117 settles upon the conclusion that these transactions secured loans, or tantamount thereto. There being no statutory deduction or exemption for this kind of loan interest, the Determination denies the refund request. We are not convinced that this conclusion is incorrect. The taxpayer has argued that

the elements of "sale" are all present so that the transactions should be properly designated as sales of federal government securities. It refers us to case law which construes the statutory term "sale" at RCW 82.04.040 in the case of transfers of tangible personal property (plastic, returnable milk containers) where the element of "valuable consideration" was lacking. This decision in Inland Dairy v. Department of Revenue, supra, is of no valuable guidance in cases such as the taxpayer's here. In fact, the element in serious doubt in this case is that of "ownership" because the right to receive interest or discount on the underlying government securities always remains in the "seller" throughout the reverse repurchase period.

While the discussion of this issue Determination 85-117 provides a more thorough response to the taxpayer's contentions, we are satisfied that reverse repurchase agreements, at best, constitute financial "investments" which derive taxable interest income. These financial business transactions are not entitled to any exemption of state business tax whether determined to be secured loans, as in Determination 85-117, or said to be involving sales of assets (government securities). In the latter case the computation of the tax would not require the value of the underlying federal obligations or the interest thereon to be considered, directly or indirectly, in violation of 31 U.S.C. 5 3124(a) for the reasons stated in Determination 85-117. We hereby affirm the findings and conclusions of Determination 85-117 in these respects.

Conclusion

Interest income derived from reverse repurchase agreements is subject to Service business and occupation tax and is not within scope of any state statutory tax exemption or 31 U.S.C. 5 3124(a).

Issue No. 4

[4] The taxpayers' only position, on this further appeal, with respect to interest derived from loans to PDAs, is that Determination 85-117 "rationalized away" the many arguments originally placed before the Administrative Law Judge. No new or different arguments have been posited on the merits of this issue. Our review of the taxpayers' petitions and the Determination reveals that the taxpayers' arguments have been thoroughly and properly treated. Determination 85-117 provides sufficient support for its findings and conclusions, so that rather than being mere rationalization, it constitutes the legally weighed and fully researched position of the Department, under the prevailing law. It is thorough and directly responsive to the taxpayers' various positions, albeit adverse to the taxpayers' interest on appeal. We hereby affirm the results of Determination 85-117 on this issue.

Conclusion

Interest derived from loans to PDAs created by cities is not entitled to the tax deduction of RCW 82.04.4293.

Issue No. 5

The dispositive conclusion of Determination 85-117 on this issue is that the Service business and occupation tax applied to gains realized from trading in U.S. Government securities is not computed, directly or indirectly, based upon any consideration of the underlying obligations or the interest thereon. We agree with that conclusion. The business and occupation tax is a nondiscriminatory business privileges tax the incidence of which is engaging in business in this state. In this instance the business engaged in is trading in evidences of indebtedness. The tax measure is the gains realized. Those gains are determined exclusively by the difference between the selling price and the purchase price of the securities. The intrinsic value of the underlying securities themselves may be worth more or less than either the purchase price or selling price received by subsequent traders and the securities may or may not be interest bearing obligations. Such considerations are completely beyond the scope of the Service business tax computation. The tax is not levied upon the value of the securities at the time of sale or at the time of their maturity; neither is the tax computation affected by the interest bearing or non-interest bearing nature of the securities or the rates of such interest. The sole consideration for application and computation of the Service business tax is whether a taxpayer has engaged in a financial business activity in this state which has resulted in any financial gain. It did, by trading in securities. Its gain was not predicted upon or determined by the value of the securities or their interest earning potential; rather, it was determined by financial market conditions, the taxpayers' liquidity needs, and its successful negotiations with other securities traders.

[5] The U.S. Supreme Court decisions and other states' court decisions cited in the taxpayers' original petition and again referred to at the Director's level hearing all reflect cases where the tax burdens in question fell, directly or indirectly, upon the value of the underlying government securities and interest earning potential. We recognize the breadth of the U.S. Supreme Court's ruling in American Bank & Trust Co. v. Dallas County, 463 U.S. ---, 77 L.ED.2d 1072 (1983). The Court considered the application of a Texas bank share tax upon the valuation of a bank's assets which included U.S. Government securities. In directly applying the provisions of 31 U.S.C. 5 3124(a) the Court said:

> . . . the tax is barred regardless of its form if federal obligations must be considered, either directly or indirectly, in computing the tax.

Clearly, under this decision, the form of the tax is immaterial. A business privileges tax like Washington's Service Business tax is as prohibited by the federal law as is an ad valorem property tax or any other tax levy, but only if its "computation" entails a consideration of the value of obligations of the United States. Herein lies the rub. Washington's Service business tax is not measured by or levied upon any government security or obligation. It is not a tax on value or interest derived from owning or selling such securities. In assessing or measuring this tax it is completely immaterial whether or not parties sold securities for more or less than their value or whether or not interest was accrued or interest earning capacity was derived by anyone. As the taxpayers' petition admits, there is no case law on point. The body of case law which prohibited state taxation of property, assets, interest income, and apportionment where the tax burden is greater or lesser because there were federal obligations (securities) involved. We are satisfied that this is not the case with application of Washington State's business privileges tax and that this distinction us substantive rather than merely formalistic. Again, Determination 85-117 explains this position at even greater length. We hereby affirm the findings and conclusions of the Determination on this question.

Conclusion

Service business and occupation tax measured by gains realized from trading in U.S. Government securities does not require any consideration of the government obligation, or its value, or interest thereon, directly or indirectly, and is not prohibited by 31 U.S.C. 5 3124(a).

Issue No. 6

[6] Determination 85-117 discusses futures contracts and interest rate swaps in considerable detail. The taxpayers' petition on appeal and its arguments at the July 31, 1986 hearing simply reiterate, in self-serving statements, that these transactions are intended to be mere hedges against market interest rate fluctuations. The overriding fact remains that these financial business transactions, whatever their purpose and whatever the taxpayers' intent may be, derive gross business receipts. There is no express statutory exemption or deduction for this income. The Determination properly includes the statutory definitions of "business," "engaging in business" and the statutory tax measures attendant thereto. The taxpayers' response has essentially been that it really does not intend to make money, or a profit, or income from these deals. The taxpayer seeks to impress us with the rationalization that it is simply good business practice in the banking industry to protect its investments and financial business undertakings by employing whatever financial mechanisms may be available to secure its assets and protect against further liability. However, to the extent that such undertakings result in

"business" activity being performed which derives revenue, the law does not predicate tax liability based upon whether the taxpayer exercises sound financial planning. Clearly, the amounts which have been taxed because of futures contracts and interest rate swaps have been actually realized as financial gain and benefit. The taxpayer uses these amounts in precisely that way, to enhance its fiscal posture and present its overall financial picture. This is not imputed income, it is actual financial business gain in the every real sense. The taxpayer has proffered no statutory or case law support for its position that these transactions should not be taxed. It has simply submitted banking and financial journal and accountancy articles and guidelines which explain these investment protective techniques and discuss how they should be accounted. We find no basis at law or otherwise for excluding the amounts derived from the appropriate Service business tax measure. While not wishing to appear summary in our treatment of this question, there is simply no legally supportable basis for tax exemption or exclusion.

Conclusion

Amounts derived from futures contracts and interest rate swaps, regardless of their purpose, constitute a part of a bank's taxable gross receipts.

DECISION AND DISPOSITION

The taxpayers' petition is denied in all respects.

Tax Assessment No. . . . is in the process of being adjusted by the Audit Section for reasons not related to this Determination and will be due on the date as indicated on the adjusted assessment.

Tax Assessment No. . . . in the amount of $48,375, including extension interest, is due for payment by January 2, 1987.

DATED this 12th day of December 1986.