Cite as Det. No. 86-309, 2 WTD 83 (1986)

THIS DETERMINATION HAS BEEN OVERRULED OR MODIFIED IN WHOLE OR PART BY DET. NO. 93-269ER, 14 WTD 153 (1995).

BEFORE THE INTERPRETATION AND APPEALS SECTION
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. 86-309
. . .	)	Registration No. . . .

[1] **RULE 109 and RCW 82.04.4281; ETB 368 and ETB 505:** B&O TAX--SERVICE--EXEMPTION--INTEREST--INTERCOMPANY LOANS--OTHER FINANCIAL BUSINESS. Interest earned from loans to subsidiaries is subject to the Service business tax where the loans are regular, recurrent, and a normal part of the taxpayer's business operations. By making loans to its subsidiaries, the taxpayer engaged in business activities comparable to those of banks, loan companies, or similar financial businesses; thus the taxpayer held not entitled to deduction provided by RCW 82.04.4281. (Rainier Bancorporation v. Department of Revenue, cited.) Excise Tax Bulletin (ETB) 368.04.224 and ETB 505.04.109.

[2] **RCW 82.04.4281:** GROSS INCOME--INTEREST--PERCENT OF GROSS INCOME. The percentage of a taxpayer's gross income which the interest represents is only one of the many factors to use in determining whether a taxpayer is in a "financial business."

[3] **RCW 82.04.4251:** DEDUCTION--INTEREST--INVESTMENTS OR USE OF MONEY AS SUCH. To be deductible under RCW 82.04.4281, the interest earned from loans must be from incidental investments of surplus funds. Interest earned from regular, recurrent loans to affiliates is not income from incidental investments of surplus funds.

[4] **RULE 203:** CORPORATIONS--INTERCOMPANY TRANSACTIONS--CONSOLIDATED FEDERAL RETURNS. The state business and occupation (B&O) tax makes no provision for consolidating returns of affiliated corporations or eliminating intercompany transactions from taxation.

[5] **RCW 82.04.4281:** DEDUCTION--DIVIDEND--DISTINGUISHED FROM INTEREST. Amounts earned from charging affiliates for the use of money falls within the definition of interest rather than the definition of a dividend. Interest earned by a parent from loans to a subsidiary is not deductible under RCW 82.04.4281 as "amounts derived as dividends."

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

TAXPAYER REPRESENTED BY: . . .
. . .
. . .
. . .

DATE OF HEARING: August 15, 1986

NATURE OF ACTION:

The taxpayer petitions for a correction of a tax assessment insofar as it assesses Service business tax on the interest received from loans to affiliates.

FACTS AND ISSUES:

Frankel, A.L.J.--The taxpayer's business includes research, development and manufacture . . . . The taxpayer's books and records were examined for the period January 1, 1981 through December 31, 1984. The audit disclosed that certain affiliated corporations are regularly charged interest on intercompany account receivable balances. For the period at issue, the amount of interest totaled over two million dollars. The auditor assessed Service business tax of $38,231 on the interest payments. (. . .)

The taxpayer contends it is not in the business of providing financial services to its affiliates; therefore the interest income should be exempt from tax. The taxpayer's petition provided the following reasons in support of its position:

(1) The taxpayer's percentages of intercompany interest to total revenues for the four fiscal years ending October 31, 1981 to 1984 based on statements prepared in accordance with generally accepted accounting principles are:

1981	.9%
1982	1.5
1983	2.0
1984	4.7
Average	2.3%

(2) The taxpayer does not require definitive cash payments of intercompany liabilities or the interest thereon. The liabilities are recorded merely to support transfers of cash, services and other properties among the taxpayer and its affiliates. However, neither the taxpayer nor its affiliates sign debt instruments. Interest is charged merely to penalize an affiliate that spends more of the taxpayer's cash than it brings to the taxpayer. The penalty works as follows: all cash generated by an affiliate becomes property of the taxpayer. Operating earnings of an affiliate must include an internal charge for interest on intercompany liabilities arising from the use of the taxpayer's cash. The more cash, services and other property transferred to an affiliate, the greater its internal interest expense. The greater the internal interest charged to the affiliate, the lower the affiliate's earnings upon which its management's bonuses are calculated. Therefore, the more an affiliate uses the cash of the taxpayer, the lower its bonuses.

However, if an affiliate contributes more cash and services to the taxpayer than it uses, the affiliate is credited with internal interest. Therefore, the more cash the affiliate generates, the more it is credited by the taxpayer and the greater the bonuses received by its management. In conclusion, intercompany interest is a device to encourage adequate cash management of an affiliate. Intercompany interest does not provide any source of revenue external to the taxpayer and its affiliates.

(3) Finally, the largest recurring source of financing during the four-year period ending October 31, 1984 is from its own and its affiliates' research and manufacturing operations.

DISCUSSION:

[1] The business and occupation tax is imposed "for the act or privilege of engaging in business activities" in this state. RCW 82.04.220. "Business" includes "all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or to another person . . ." RCW 82.04.220.

The B&O tax is calculated on the "gross income of the business" unless otherwise exempted. RCW 82.04.290. "Gross income of the business" includes proceeds received from interest. RCW 84.04.080. Interest earned from loans is taxable under RCW 82.04.290, which imposes the Service classification B&O tax.

The taxpayer claims a deduction under RCW 82.04.4281, which reads as follows:

> In computing tax there may be deducted from the measure of tax amounts derived by persons, other than those engaging in banking, loan, security, or other financial businesses, from investments or the use of money as such, and also amounts derived as dividends by a parent from its subsidiary corporations.

In interpreting this statutory provision, the taxpayer and the Department both rely on two Washington Supreme Court cases: John H. Sellen Construction Co. v. Department of Revenue, 87 Wn.2d 878 (1976) and Rainier Bancorporation v. Department of Revenue, 96 Wn.2d 669 (1982). Sellen concerned several taxpayers who had invested a portion of their surplus or reserve funds in short term investments as savings deposits, CDs, commercial paper, stocks, and bonds. The Department had assessed the B&O tax on the income earned from these investments. The court, however, found the income exempt under RCW 82.04.430(1), the prior codification of RCW 82.04.4281.

The court discussed several rules of statutory construction which it stated "lended force" to its interpretation of the deduction statute. 87 Wn.2d at 882-84. The court contended the Department's position in that case would allow few taxpayers, if any, "making incidental investments of surplus funds" to receive the deduction . Id. at 883.

The court approved, however, the Department's previous interpretation of the deduction statute, stating it was "consistent with" the court's position. Id. at 884. The court quoted with approval the Department's definition of other financial business as set forth in ETB 368.04.224 (June 1970):

> But it does not follow that every act of business or every investment and grant of the use of money is held to be financial business. . . . Where the activities involved are essentially in competition with financial businesses and this is a regular part of the taxpayer's normal business practice, the department believes that the activities constitute financial business and are subject to tax.

The court stated the Department's most recent determinations had reflected a change in the previous position. Id. at 884, n.6.

After Sellen, the Department issued ETB 505.04.109 which discusses Sellen and restates the position set forth in ETB 368:

> The court did not define "investments" in its opinion. However, it noted that enterprises "specializing in the handling and investment of funds" would not be entitled to the statutory deduction but that those "making incidental investment of surplus funds" should receive the deduction.
>
> Under the holding of the court in Sellen, income from the incidental investment of surplus or excess funds by persons who are not themselves in a security, investment, or financial business is not subject to tax.
>
> However, no deduction is permitted with respect to
>
> . . .

3. income from activities which are essentially in competition with financial businesses where such activities are a regular part of the taxpayer's normal business practice.

In 1982, when the court again considered the issue in Rainier Bancorporation v. Department of Revenue, supra, it upheld the service tax on interest earned by the taxpayer, from loaning money to its subsidiaries. The court noted Rainier Bancorporation did not fall within the specific definition of a banking, loan, or security business; and that its activities did not include loaning money to the public at large and were not identical to those of a bank, loan, or security business. 96 Wn.2d at 674. The court found, though, that "by loaning money to its subsidiaries Rainier's activities are similar or comparable to those aforementioned businesses." Id. Also, the court said it was "important to remember that tax deductions must be narrowly construed." Id.

We believe Rainier supports the decision that the tax on the taxpayer's income earned from the loans to its subsidiaries is valid. This decision is consistent with ETBs 368 and 505 and numerous previous decisions by the Department which have held that interest income from loans to affiliated corporations, where the loans are a regular and normal part of the taxpayer's business activities, is subject to the Service business tax. If the affiliated companies had not been able to borrow funds from the taxpayer, they would have had to borrow from a commercial financial source. Thus, the taxpayer's regular practice of loaning funds to its affiliates is in competition with financial businesses. Although the taxpayer may not be a financial business, it has engaged in financial business activity on a regular and recurrent basis and its income from that activity is subject to the Service business tax.[1]

[2] The taxpayer contends Rainier Bancorporation is distinguishable because the interest income received by Rainier amounted to approximately half of its gross income during the audit periods at issue. 96 Wn.2d at 673, n.2. In the present case, the taxpayer's interest income from the intercompany loans averaged 2.3 percent. We do not find that fact is controlling, however.

In Rainier, the court noted that the percentage of the taxpayer's gross income which the interest represents is only one of the many factors to use in determining whether the taxpayer is in a "financial business." The court stated it was not adopting a "percentage test." Id.

In determining whether the income was received from an activity that is a regular part of the taxpayer's normal business practice, the Department considers the number of loan transactions and whether the act of making loans fits into the general scheme of the taxpayer's normal business practice, as well as the percentage of the taxpayer's gross income which the interest represents.

Although the percentage of the taxpayer's gross income represented by the intercompany interest is small, the amount of interest was substantial. Also, the loans were made regularly over a number of years and the income is within the regular scheme of the taxpayer's normal business practice.

[1] The Department has distinguished cases where the money loaned was borrowed from banks and the loans were a "pass-through" to an affiliate corporation. In such limited cases, the loans were not considered in competition with financial businesses.

[3] Even if the taxpayer were not considered engaging in a financial business, though, to meet the test of the deduction provided by RCW 82.04.4281 the income must be derived from investments of the use of money as such. In Sellen, the court stated that an interpretation of "investment" should be limited to the plain and ordinary meaning of the word. 87 Wn.2d at 883. Sellen allowed a deduction for income from a business's "incidental investments of surplus funds . . ." As noted above the taxpayers involved in Sellen had invested surplus or reserve funds in savings deposits, commercial paper, time certificates, stock, bonds and other similar investments. Unlike the present case, none of the income was from loans or activities which could be considered in competition with financial businesses.

In O'Leary v. Department of Revenue, 105 Wn.2d 679 (1986) the court quoted the Sellen case and concluded that "[w]hether an investment is 'incidental' to the main purpose of a business is an appropriate means of distinguishing those investments whose income should be exempted from the B&O tax of RCW 82.04.4281." Id. at 682. In O'Leary, the court found the real estate contracts at issue which were held by the taxpayer investment partnership were not incidental investments.[2]

Similarly, we do not believe interest from the loans to affiliates is incidental to the taxpayer's business. The taxpayer stated that it acquired the affiliates to enhance the value of its company. The taxpayer stated interest is charged on its loans to affiliates to encourage them to utilize adequate cash management.[3] The business and occupation tax is not limited to the primary business of a taxpayer, but includes all activities engaged in with the object of gain, benefit or advantage. RCW 82.04.220. The legislature has provided for different tax rates upon different parts of the business activity of one corporation. Rena-Ware Distribs., Inc. v. State, 77 Wn.2d 514, 463 P.2d 622 (1970).

[4] Additionally, the taxpayer contended that the interest income should not be subject to tax because the interest is not really income to the company as a whole, i.e., it does not increase the worth of the company. In making this assertion, the taxpayer noted it has elected to file a consolidated return for federal tax purposes. The taxpayer contends that the "family" corporate balance sheet does not improve if a parent loans money to a subsidiary corporation and charges interest.

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[2] Chief Justice Dolliver wrote O'Leary and the other eight justices concurred. Justice Dolliver had dissented in the Rainier Bank case. He criticized the majority in Rainier for not limiting "other financial businesses" to one that was in a "public, competitive business." 96 Wn.2d at 677. We note, however, that since that opinion in 1982, the legislature has met several times but has not amended RCW 82.04.4281 to exclude interest earned from loans to affiliated corporations. Also, in O'Leary, Justice Dolliver stated to qualify for the deduction in RCW 82.04.4281, a taxpayer must show both that the interest was from incidental investments and that it was not in a financial business.

[3] This fact distinguishes Howard S. Wright Construction Company and Schuchart Industrial Contractors, Inc. v. Department of Revenue, Thurston County No. 79-2-01310-0 (May 21, 1981), on which the taxpayer also relied. In Wright-Schuchart, the court found the interest income earned from loans to affiliated companies was exempt. The primary source of funds loaned to the affiliates, however, was from borrowing from banks and the primary purpose for making the loans was to make financial administration of the overall operation more efficient. The court found it was easier for Wright-Schuchart to maintain two lines of credit rather than a line of credit for each affiliate. We believe that case is distinguishable on its facts.

Nevertheless, as the auditor noted, for state business tax purposes charges against or income derived from affiliates may not be excluded from taxable income. See WAC 458-20-201, WAC 458-20-203 and ETBs 50.04.203, 86.04.201.203, and 90.04.203, copies of which the auditor provided to the taxpayer. As Rule 203 states, "the law makes no provision for filing consolidated returns by or for the elimination of intercompany transactions from the measure of the tax."

[5] The taxpayer also argued the interest income was similar to a "dividend" and used to provide incentive to the affiliates. Accordingly, the taxpayer contends the income should be exempt under the deduction provided by RCW 82.04.4281 for "amounts derived as dividends" by a parent from its subsidiary corporations." We do not believe the income in this case was paid as a dividend, however. As the Sellen court noted, "Words in a statute are given their ordinary and common meaning absent a contrary statutory definition." 87 Wn.2d at 882. The court also noted that dictionaries are often relied on to determine the common meaning of statutory language. Id. at 883.

Black's Law Dictionary defines interest for money as "the compensation allowed by law or fixed by the parties for the use or forbearance or detention of money." (Fourth ed. 1968 p. 950) Dividends are defined as

> . . . The share allotted to each of several persons entitled to share in a division of profits or property. Thus, dividends may denote a fund set apart by a corporation out of its profits, to be apportioned among the shareholders, or the proportional amount falling to each. Id. at 565.

The income that was taxed in this case was not earned from the profits of the affiliated companies, but was earned from charging the affiliates for the use of the taxpayer's money. Clearly, the income falls within the definition of interest rather than the definition of a dividend. We do not agree, therefore, that the amounts are excludable as "amounts derived as dividends."

As stated above, deductions are to be narrowly construed. By providing for a deduction for dividends, we do not find the legislature was also providing for a deduction for interest earned by a parent from loans to a subsidiary.

DECISION AND DISPOSITION:

The taxpayer's petition for correction of Assessment No. . . . is denied.

DATED this 5th day of December 1986.