Cite as 2 WTD 285 (1986)

BEFORE THE INTERPRETATION AND APPEALS SECTION
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. 87-63 Registration No. . . . Tax Assessment No. . . .

[1] **RULE 179; RCW 82.04.417:** B&O AND PUBLIC UTILITY TAX -- EXEMPTION -- CHARGES FOR CAPITAL COSTS. Revenue received as a result of monthly payments for services rendered is taxable gross income even if used wholly or in part for capital purposes; the revenue received for billing a customer for constructing a distribution system to his property is not taxable gross income. (King County Water District 68 v. Tax Commission, Kennewick v. State and Seattle v. State cited.)

[2] **RULE 179; RCW 82.04.417:** B&O AND PUBLIC UTILITY TAX -- EXEMPTION -- CHARGES FOR RETIREMENT OF BONDS ISSUED FOR CAPITAL PURPOSES -- REQUIREMENT FOR EXEMPTION. Income from charges to customers for bond retirement on capital projects is excludable under RCW 82.04.417, even if the utility designates the income as a "service charge," if the revenue is separately accounted for, used exclusively for the bond retirement and there is "special authority" for its collection.

[3] **RULE 179; RCW 82.04.417:** B&O AND PUBLIC UTILITY TAX EXEMPTION -- CHARGES FOR RETIREMENT OF BONDS ISSUED FOR CAPITAL PURPOSES -- REQUIREMENT FOR EXEMPTION -- ORDINANCES ESTABLISHING BOND FUND. City ordinances establishing bond funds can constitute the "special authority" for the collection of the bond funds to

meet the Department of Revenue's requirement for exemption under RCW 82.04.417.

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: September 11, 1986

NATURE OF ACTION:

The taxpayer, a city water and sewer utility, seeks a refund of the tax paid on a portion of its revenue transferred into a debt retirement fund and used for servicing revenue bonds. The taxpayer contends the amounts are entitled to the deduction provided by RCW 82.04.417 as "contributions in aid of construction."

FACTS AND ISSUES:

Frankel, A.L.J.--In December of 1985 the taxpayer's budget analyst sent the Department a letter requesting a refund of $ . . . in business and occupation (B&O) taxes believed to have been overpaid, plus interest as provided by RCW 82.032.060. Primarily, the taxpayer requested a refund of taxes paid on revenues it contended should have been deducted as "contributions in aid of construction," as provided by RCW 82.16.043 and 82.04.417. A deduction was claimed for revenue which was transferred into a debt retirement fund and used for servicing revenue bonds.

A revenue auditor reviewed the city records for the period at issue, Januaryá1, 1981 to Octoberá31, 1985, and tentatively concluded the city was entitled to the refund. Upon further review, however, the audit supervisor concluded the city was not entitled to the deductions; thus the refund request was denied.[1] The letter denying the refund stated:

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[1]The city was granted a refund of overreported sewerage income for billings to other municipal sewerage utilities. The issue in this appeal only concerns the denial of a refund for amounts the city believed should have been deducted as "contributions in aid of construction."

> The largest portion of the refund request deals with amounts you believe should have been deducted as "contributions in aid of construction". A number of years ago the City of . . . expanded its utility facilities. The funds for this expansion came from the issuance of revenue bonds. The city ordinances require that a portion of the income from the sale of the services be set aside in a special fund for the payment of interest and future retirement of the bonds. The City had not deducted the amounts set aside for payment of interest and retirement of the debt.
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> We have carefully reviewed all of the information supplied by our auditor and have concluded that the City was properly not deducting these "contributions in aid of construction". WAC 458-20-179 sets forth the various deductions. The deduction for contributions in aid of construction is discussed in item 6. One significant statement appears to have been overlooked which reads "Service charges shall not be included in this exemption even though used wholly or in part for capital purposes".
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> The City is making a charge to its customers for services. This charge is for either water which is provided to the customer or for sewage disposal services. It is my understanding that the billing to the customer does not identify any portion of the charge as being for debt retirement. The charge is solely for the service provided. Even if a portion of this charge goes for debt retirement, it would not be deductible. The ordinances do not identify the specific dollar amount of a customer's charge which is for debt retirement. A provision is made by ordinance to transfer amounts from general revenues to a special fund for purposes of having amounts available to service the debt. However, I believe revenue bonds by their very nature are issued on the assumption that revenue generated from the facility for which the bonds were issued will be used for debt retirement.

(Letter of March 4, 1986.)

The taxpayer was advised that for future reporting purposes it could enact an ordinance establishing a specific dollar amount from each billing which would go into the debt retirement

fund. Such amounts would meet the Department's requirement for deductibility under RCW 82.04.417. The city has now enacted such an ordinance. This appeal concerns the denial of the refund for the earlier periods.

During the hearing, the taxpayer's attorney argued that the denial was totally "unfair." He argued that if the utility had paid for capital items with cash or collected the same funds at issue by specifically stating the amounts as separate charges on the customer's bill, the deduction would have been permitted. He stated that the Department denied the refund because the city "didn't jump through the right hoops" and because it was "on the wrong side of the mountains." He argued the denial was arbitrary, contending the Department has no standards or rules informing a city how to meet the deduction requirements.

The taxpayer requested more time after the hearing to supply additional information supporting its position. It did so on Decemberá22, 1986. The voluminous materials include, inter alia, an additional Memorandum in Support of the Petition, sections of the city code, city charter, affidavits by the budget analyst and Utility Rate Advisory Board, copies of the relevant city ordinances and resolutions, agendas of the Utility Rate Advisory Board, opinion letters regarding the Bond Anticipation Note, and photographs of sewer construction.

DISCUSSION:

[1] RCW 82.04.417, the exemption provision at issue, was enacted in 1969. The statute provides:

> 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 payment 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.

A review of Washington court cases considering whether amounts collected and used for capital expenses were exempt from the public utility tax or the B&O tax, indictes the court has narrowly construed the exemption for capital expenses. In King County Water District 68 v. Tax Commission, 58 Wn.2d 282 (1961), the Department of Revenue had included amounts charged customers for installation and inspection of water mains and meters in the measure of the public utility tax on the ground the income constituted "operating revenue" within the meaning of RCW 82.16.010(12)[2]

The court found that constructing, installing, and inspecting facilities for the purpose of operating a plant do not constitute operations of such facilities. In that case, the charges at issue were to qualify the parties or make them capable of purchasing water rather than consideration for their purchase of water itself from the water district. The court upheld the refund because the revenue was not operating revenue accruing from the performance of a water distribution business.

Using the same analysis, the Court granted a refund to the city of Seattle for revenue received from prospective customers as reimbursement for construction and installation

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[2]The public utility tax is imposed on the act or privilege of engaging within this state in any one or more of the businesses listed in RCW 82.16.020, and includes water distribution. The tax is on the "gross income of the business" which is defined in RCW 82.16.010(12) as

> . . . the value proceeding or accruing from the performance of the particular public service or transportation business involved, including operations incidental thereto, but without any deduction on account of the cost of the commodity furnished or 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 . . .

Prior to a 1959 amendment, the statute imposed the tax on the "gross operating revenue" rather than "gross income." The definitions of the two terms are identical, however.

of facilities. Seattle v. State, 59 Wn.2d 150 (1961). The Court held that revenue received from prospective customers did not constitute consideration for delivery of water by the district and, therefore, did not constitute part of the "gross operating revenue" within the meaning of RCW 82.16.010(12).

In 1965, the Washington Supreme Court again considered the issue of the public utility tax upon the revenues received by a city from the operation of its water system. Kennewick v. State, 67 Wn.2d 589 (1965). Three categories of revenue were involved in the appeal: (1) funds received from prospective water users who had reimbursed the city for capital expenditures which enabled them to receive water service--funds designated by the city as "in aid of construction," (2) revenues derived from the operation of the city's water system, and (3) revenues derived from the operation of the sewer system.

As in the present case, the city argued that part of the revenue from the operation of the sewer and water system included amounts calculated to pay the principal and interest on bonds issued for capital construction. The city contended that such revenue was not subject to the public utility tax or the B&O tax, because it was used exclusively to finance the capital expansion of its water system. 67 Wn.2d at 591, 594. The court disagreed.

The court found the King County and Seattle cases discussed above distin-guishable because they involved reimbursements for installation costs which arose prior to the time any water was delivered or sold to the users. The court found Kennewick's operation of its water system clearly within the purview of the public utility tax.

The court also upheld the B&O tax assessment on the revenues received "in aid of construction." These funds had been reclassified from the public utility tax to the Service classification of the B&O tax in June of 1962. The court noted that while such income was not gross income within the purview of the public utility tax, the payment fell within the "gross income of the business" as defined for B&O tax purposes. 67 Wn.2d at 593-94.

It was after the Kennewick decision that the legislature enacted RCW 82.04.417. Clearly, had the statute been in effect prior to Kennewick, we believe the revenue received "in aid of construction" would have been exempt from the B&O tax. Whether the result would have been different as to the amounts

included in service charges that were calculated to raise sufficient revenue to pay the principal and interest on bonds issued for capital construction--revenue that is at issue in the present case--is not as clear.

In the subsequent case of Seattle v. State, 12 Wn.App. 91 (1974), the court stated the legal principles in Kennewick were still applicable. 12 Wn.App. at 96. The court held Seattle was entitled to a refund for excise taxes paid on revenue received exclusively for the cost of conversion from an overhead to an underground electric power distribution system. The court noted that those payments were separately billed and not part of the utility's "regular charge" for electric service. 12 Wn.App. at 92.

The court reasoned that this distinguished the revenue from that received by the City of Kennewick, noting "the obligation and payment was in no way connected with the general obligation of all the utility's customers to pay the monthly rate for services rendered." 12 Wn.App. at 96.

The court clearly did not overrule Kennewick and summarized the distinction for the exemption as follows:

> On the other hand, the City of Kennewick was essentially attempting to exclude from the public utility tax amounts that had been received by the City as a result of monthly charges made by the City to all its customers for the supply of water. The revenue received as a result of such monthly payments for services rendered is taxable gross income of the utility, pursuant to RCW 82.16, while the revenue received as a result of billing the customer for the cost of constructing a distribution system to his property is not.

12 Wn.App. at 96-97.

In the present case, the taxpayer contends that the amounts required by ordinance to be budgeted for and that are used for debt retirement meet the exemption requirement. The taxpayer contends such funds are received as a result of billing the customer for capital costs rather than for services rendered, even though the charges are not separately stated.

[2] The Department's position is to allow an exemption for collections for bond retirement upon certain conditions. These conditions are as follows:

1. The billing to the customer must clearly identify the charge as being for retirement of revenue bonds and the amount of such charge must be separately stated from any other charges on the same bill.

2. Revenues derived from this source must be separately accounted for in the books of the city and may not be commingled with other funds.

3. Income from this source must be used exclusively for the retirement of revenue bonds and may not be used for any other purpose.

Separate itemization on billings is not required if the additional charge for bond retirement is authorized by city ordinance or resolution as a separate charge from utility services rendered, and if the second and third conditions are satisfied. In such cases, the Department considers the charges as "payments of special assessments or installments thereof" representing a share of the cost of capital improvements.

The taxpayer contends it meets the Department's requirements for exemption. It stated that the revenue for the retirement of the bonds is separately accounted for and not commingled with other funds; the income from the bond fund is used exclusively for the retirement of revenue bonds; and that the city ordinances require that customers be billed for bond retirement.

[3] We agree that the ordinances authorizing the issuance of the water and sewer revenue bonds constituted the "special authority" for the collection of the charges at issue. The ordinances provided for bond funds to be established in which a portion of the gross revenues of the system are pledged to pay the principal and interest on the bonds as they became due. Instead of specifying dollar amounts to be paid into the bond funds, the ordinances require the city to pay into the fund one-sixth of the interest next due and one-twelfth of the principal due. . . . The ordinances also require that the annual net revenue from the system be at least 1.40 times the maximum of principal and interest required to be paid with respect to indebtedness.

We also agree with the taxpayer that the ordinances and the rate-setting process give customers notice that their bills

include amounts for capital purposes. Rates are reviewed by an engineering firm, the Utility Rate Advisory Board, and adopted by the City Council at meetings which are open to the public.

Each year the city budget analyst prepares a projection of the amount to be paid for principal and interest on bonds. A copy of a sample computer printout is attached to this Determination. The Advisory Board and the City Council consider this information in setting the rates (. . .).

An exemption is not permitted for income simply because it is credited to a capital account. The taxpayer stated that it is not asking for an exemption for "leftover" service charges used for capital purposes, but only for funds collected and used for debt retirement in accordance with budgeted ordinance requirements. We find that such amounts are excludable under RCW 82.04.417, as charges "for the retirement of obligations and payment of interest thereon issued for capital purposes." The charges for bond retirement are similar to ULID and LID assessments which the Department has found excludable under RCW 82.04.417. See ETB 336.04.179.

DECISION AND DISPOSITION:

The taxpayer's petition for a refund is granted.

DATED this 27th day of February 1987.