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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. 87-333 Registration No. . . . Tax Assessment No. . . .

[1] **RULE 109, RULE 118, RCW 82.04.080 AND RCW 82.04.4281:** SERVICE B&O --INTEREST -- REAL ESTATE CONTRACTS -- SELLER FINANCED MORTGAGES.
The taxpayer was engaged in the business of buying and selling apartment buildings. Interest payments received through real estate contracts are part of the gross income of the business and subject to Service B&O, unless the real estate contracts constitute investments and the taxpayer is not engaged in a financial business. O'Leary v. Department of Revenue, 105 Wn.2d 679 (1986).

[2] **RULE 224, RCW 82.04.080, RCW 82.04.290:** SERVICE B&O -- APARTMENT MANAGEMENT. Income from managing apartments is taxable under Service B&O.

[3] **RULE 178, RCW 82.12.010, RCW 82.12.020:** USE TAX. Use tax is due for purchases of consumables, where the taxpayer cannot substantiate that retail sales tax was paid.

[4] **RCW 82.32.070:** DUTY TO MAINTAIN RECORDS. A Washington taxpayer must maintain business records for five years past.

TAXPAYER REPRESENTED BY: . . .
. . .

DATE OF HEARING: June 12, 1987

NATURE OF ACTION:

The taxpayer petitions for a refund of Retailing and Service B&O tax, retail sales tax, and use tax.

FACTS AND ISSUES:

Normoyle, A.L.J. -- The taxpayer was audited for the period from January 1, 1982, through December 31, 1985. During the audit period he was engaged in a variety of business activities, including operation of a restaurant, management of apartment buildings, and purchasing and selling apartments (through a partnership).

The auditor assessed Service B&O tax, for unreported service income; retail sales tax and Retailing B&O, for underreported retail sales; and use tax for purchases of consumables.

The appeal may be broken down into four categories:

(1) Seller financed mortgages (Service B&O -- Schedule II). The auditor found that the taxpayer received unreported interest income from "seller financed mortgages" relating to sales of apartment buildings. The auditor relied on the taxpayer's federal income tax returns. The taxpayer claims that this income was incorrectly reported as seller financed mortgages, on those returns, by his previous accountant, and that this "income" was actually not income at all. Rather, the taxpayer had made personal loans to friends and associates and what appeared on the federal return as seller financed mortgages was simply repayment of these loans.

Further, the taxpayer claims that, on some of the apartment sales, he received little or no income, as there were underlying bank mortgages which he paid with the payments he received from the buyers.

Finally, the taxpayer claims that one of the "seller financed mortgages" was not a mortgage at all. The taxpayer states that he gave $130,000 to the owner of a real estate company, to hold for him, in trust, until a suitable apartment became available for purchase. According to the taxpayer, "some interest" was paid to him by the real estate company, but the company then went bankrupt and the taxpayer stands to lose all or most of his investment.

(2) Apartment management fees (Service B&O -- Schedule II). The taxpayer was the manager of the partnership apartment buildings. The auditor, again using information from federal tax returns, assessed Service B&O on amounts reported on the returns as apartment management fees.

The taxpayer claims that not all of that income was actually for apartment management--some of it was a return on his investment, and not taxable as service income.

(3) Restaurant income (Retailing B&O and retail sales tax -- Schedule III). The auditor assessed tax for underreported retail sales. The amount of retail sales reported on the federal tax returns for the period in dispute was $68,151. The taxpayer's state excise tax returns reported retail sales of $62,354. His present accountant stated, at the administrative law judge hearing, that the figure in the federal return was incorrect -- the $68,151 had mistakenly included the retail sales tax collected. The true retail sales was $63,220, according to the accountant.

(4) Use tax (Schedule V). The auditor assessed deferred sales tax/use tax on over $100,000 in purchases of material and labor by the taxpayer. The purchases were, in part, for his personal residence, for the restaurant, and for various apartment buildings. The taxpayer could not provide the auditor with proof that sales tax was paid for each purchase, but claims that tax was paid to some of the sellers.

At the conclusion of the administrative law judge hearing, the taxpayer and his accountant were told that verification would be required as to their claims under categories 1, 2, and 4, above. They stated that they could do so within two weeks. They were also told that the issues under category 3 would be referred back to the auditor for resolution.

The hearing was on June 12, 1987. On July 13, 1987, the administrative law judge wrote to the accountant, stating:

> At the conclusion of the conference on June 12, 1987, you had agreed to provide me with additional information, within two weeks of that date. I have not yet received that information. In order for me to consider it, please supply that information to me within one week of this letter.

As of the date of this Determination, the taxpayer and his accountant have provided no such documentation.

DISCUSSION:

1. Service income from "seller financed mortgages".

The auditor concluded that the taxpayer was engaged in the business of buying and selling apartments and that the interest income from the sale of the apartments was subject to Service B&O tax.

The taxpayer argues that, as a factual matter, much of the income attributed to these "seller financed mortgages" was not taxable income. Rather, it was either repayment of loans to friends or associates, or the payments went to an underlying mortgage, or it was interest received from money paid to the real estate company, in trust.

We believe that Washington Administrative Code (WAC) 458-20-109 and 458-20-118,[1] and the case of O'Leary v. Department of Revenue, 105 Wn.2d 679 (1986), dispose of this issue. In O'Leary, as here, a taxpayer partnership bought and sold apartment buildings. There, as here, the sales were by real estate contract,[2] with the partnership receiving periodic principal and interest payments. The Department of Revenue assessed Service B&O on the interest payments. The partnership (M & R) argued that the real estate contracts were investments and that the interest payments were deductible under RCW 82.04.4281. The Supreme Court rejected the taxpayer's argument, stating:

> The Washington Legislature has imposed a business and occupation tax "for the act or privilege of engaging in business activities" in this state. RCW 82.04.220. "Business" is defined in RCW 82.04.140 to include "all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or to another person . . ." Clearly, under this broad definition, the partners in M & R are conducting business activities and are, therefore, subject to the B&O tax.
>
> Subject to narrowly circumscribed exceptions, the B&O tax owed is calculated based on the "gross income of the business". RCW 82.04.290. "Gross income of the business" is defined in RCW 82.04.080 to specifically include interest:
>
> > "*Gross income of the business*" means 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*. . .
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> (Italics ours.) Thus, unless M & R can prove it is entitled to a statutorily enumerated deduction or exemption, the interest payments received through its

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[1] Persons who are engaged in the business of selling real estate on time or by installment contracts are subject to Service B&O tax on the interest income.

[2] Even though called "seller financed mortgages" in this taxpayer's federal returns, the audit shows them to be real estate contracts. The taxpayer did not refute this finding and, in fact, referred to them as "contracts," at the hearing.

real estate contracts are part of the gross income of the business and, accordingly, are subject to the B&O tax.

The partners in M & R contend RCW 82.04.4281 entitles them to deduct the interest received through M & R's real estate contracts. RCW 82.04.4281 provides:

> 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.

For the partners to qualify for the deduction, they must show both (1) the real estate contracts from which they received interest constituted investments, and (2) M & R is not engaged in a financial business.

[1] To decide if the partners meet the first requirement, we must define investment and then determine if the real estate contracts meet that definition. Exemptions to the tax laws are to be construed narrowly. *Budget Rent-A-Car of Wash.-Or., Inc. v. Department of Rev.,* 81 Wn.2d 171, 500 P.2d 764 (1972). "Taxation is the rule and exemption is the exception." *Budget Rent-A-Car*, at 174.

[2] As we stated in *John H. Sellen Constr. Co. v. Department of Rev.,* 87 Wn.2d 878, 883, 558 P.2d 1342 (1976), an interpretation of an "investment" should be limited to the plain and ordinary meaning of the word. In *Sellen* we allowed a deduction for income from a business' "incidental investments of surplus funds . . ." *Sellen,* at 883. Whether 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. Here the real estate contracts held by M & R investment partnership were neither incidental investments nor were they made from surplus income of the partnership.

We previously have determined the vendor of a real estate contract may be treated differently than other holders of debt investments. We directly addressed this contention in *Clifford v. State,* 78 Wn.2d 4, 8, 469 P.2d 549 (1970) stating:

> Making a loan and taking a land contract as security is not the same activity as selling a

> piece of land and accepting the payment in installments. In one activity, money is advanced. In the other, no money is advanced by the seller; rather he relinquishes the right to immediate payment.
>
> It is uncontroverted that plaintiffs derived the interest income at issue from a financing method which permitted deferred payment. The plaintiffs expected and received interest for allowing their buyers to make payments on time.
>
> The plaintiffs' sale of their apartments was not an investment "or the use of money as such". The plaintiffs are not entitled to a deduction under the provisions of RCW 82.04.4281. Therefore, we need not determine if they are engaged in a "financial business".[3]

As the present case parallels O'Leary, and as the taxpayer, despite an opportunity to do so, has not substantiated the claims made at the hearing, we must sustain the Service B&O assessment on interest income from these real estate contracts.

2. Apartment management fees.

The auditor, again using the federal tax returns, assessed the Service B&O for income to the taxpayer for apartment management. The taxpayer claimed that some of this "income" was simply a return of his investment and not income at all. However, he has not substantiated this claim either, and we cannot simply ignore the information contained in his own federal tax return. Income from apartment management is taxable under Service B&O. RCW 82.04.080, RCW 82.04.290, and WAC 458-20-224.

3. Restaurant income.

The taxpayer claims that an error by his prior accountant resulted in his having declared approximately $6,000 more in retail sales than he should have. The error was that the accountant added the collected retail sales tax to the retail sales. This issue is referred back to the auditor for resolution. If the taxpayer or his representative do not supply adequate proof of the correct retail sales, by November 16, 1987, the assessment shall be considered final and the petition for a refund of this portion of the assessment will be denied. If the taxpayer does provide documentation within this time limit, the Department will refund the overpayment.

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[3] See also, Browning v. Department of Revenue, 47 W. App. 55 (1987), where the court of appeals followed the holding of O'Leary.

4. Use tax.

The auditor assessed use tax pursuant to RCW 82.12.020 and WAC 458-20-178, for over $100,000 of purchases of goods and labor. The taxpayer could not prove to the auditor that retail sales tax was paid on all of these purchases. At the conclusion of the administrative law judge hearing, he was given an additional opportunity to substantiate his claim that retail sales tax had indeed been paid on some or all of these purchases. He has not done so and we must also sustain this part of the assessment.

5. Duty to maintain records.

We note in passing that RCW 82.32.070 "requires each taxpayer to keep, for a five-year period, suitable records as may be necessary to determine the amount of any tax. . . ." Much of the taxpayer's grief could have been avoided had he complied with this statute.

DECISION AND DISPOSITION:

The petition for refund, as it pertains to Schedules II and V of Tax Assessment No. . . . , is denied. The petition for refund of taxes paid under Schedule III (retail sales tax and Retailing B&O) is referred back to the Audit Section, for disposition in accordance with this Determination.

DATED this 26th day of October 1987.