

Cite as Det. No. 87-346, 4 WTD 267 (1987)

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 DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition)	<u>D E T E R M I N A T I O N</u>
For Correction of Assessment)	
)	No. 87-346
)	
[ABC] HOTEL COMPANY)	Registration No. . . .
...)	
)	
[ABC] MARKETING COMPANY)	Registration No. . . .
...)	
)	

- [1] **RULE 203:** B&O TAX -- GROSS INCOME -- EARNINGS OF SUBSIDIARIES AND AFFILIATES -- EQUITY METHOD OF ACCOUNTING -- INCOME RECORDED SOLELY TO PREPARE CONSOLIDATED FINANCIAL STATEMENT. The recording of the net income of subsidiaries and affiliates as income on the taxpayer's books does not result in taxation when: the taxpayer uses the equity method of accounting; the income is recorded solely for the purpose of preparing consolidated financial statements, and; no income is actually received by the taxpayer.
- [2] **RULE 203:** B&O TAX -- GROSS INCOME -- SERVICES TO SUBSIDIARIES - - INCREASE IN INVESTMENT IN SUBSIDIARIES ACCOUNT. A taxpayer who provides services to subsidiaries and who, rather than receiving payment for those services, increases the amounts recorded as investments in the subsidiaries is taxable in the amount of the increases. Increases in investment accounts are increases in the assets of the taxpayer and result from services rendered. Thus, they are "other emoluments" received from engaging in business.
- [3] **RULE 109:** B&O TAX -- SERVICE -- GROSS INCOME -- INTEREST -- LOANS TO EMPLOYEES. Interest derived from loans to employees is subject to tax. The making of loans is a financial business. Therefore, the deduction provided by RCW 82.04.4281 is not available.

- [4] **RULE 194:** B&O TAX -- SERVICE -- GROSS INCOME -- APPORTIONMENT -- SERVICE PROVIDED OUT OF STATE BY THIRD PARTY. A taxpayer operating a hotel reservation system is entitled to apportion income it receives from customers for their proportional share of services provided to the taxpayer by a third party. The third party had a computer system which interfaced with the taxpayer's computer system, both located out of state. The third party billed the taxpayer who re-billed its customers. The only activity taking place in Washington was accounting by the taxpayer. Because the taxpayer's out-of-state facilities interfaced with the third party's system they contributed to the service for which the taxpayer billed its customers. Apportionment was thus appropriate.

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: October 24, 1986

NATURE OF ACTION:

The taxpayers, who are related companies, petitioned for correction of assessments issued as a result of audits of their business activities.

ISSUES:

Potegal, A.L.J. --

[ABC] Hotel Company

1. In Schedule VI of the original audit report, are amounts recorded as income from affiliates and subsidiaries on the taxpayer's own books subject to tax?
2. In Schedules III and IV of the original audit report, are amounts described as reimbursements taxable where the taxpayer states they were not actually received?
3. In Schedule V of the original audit report, are certain types of interest income deductible from the measure of tax under RCW 82.04.430(1)?

[ABC] Marketing Company

1. In Schedule II of the original audit report, is income from reservation services subject to tax?

2. In Schedule III of the original audit report, is a payment of \$. . . to a printer properly includable within a sample used to determine sales or use tax liability on the purchase of consumables?
3. In Schedule II of the original audit report, were out-of-state media advertising costs excluded from the calculation of an apportionment formula?

DISCUSSION:

The discussion will follow the order presented in the ISSUES section.

[ABC] Hotel Company

1. The amounts upon which tax was assessed in Schedule VI were recorded on the taxpayer's general ledger as income from affiliates and subsidiaries. According to the taxpayer these were merely bookkeeping entries to facilitate the preparation of consolidated financial statements. The amounts entered were the taxpayer's share of the net earnings of the affiliates and subsidiaries and were not actually paid to the taxpayer. Under the equity method of accounting this is an entirely appropriate procedure which does not represent any actual income to the taxpayer. The taxpayer makes the point that if these earnings were actually paid to the taxpayer payment would be as dividends which would be exempt from tax under RCW 82.04.430(1).

[1] Consultation with the Department's senior audit staff leads us to agree with the taxpayer in theory. However, it should be possible for the taxpayer to prove this through work sheets or other documentation showing the net income and percentage of ownership of the affiliates and subsidiaries which led to the figures entered on the general ledger as income. This matter will be referred back to the audit staff for verification.

2. The amounts in question here were paid by the taxpayer as salaries to employees providing services to subsidiaries and as non-salary expenses incurred in providing services to subsidiaries. The taxpayer invoiced the subsidiaries for these amounts and set them up as accounts receivable. The taxpayer then credited these accounts receivable and debited accounts titled "Investment in Subsidiaries" in the same amounts. The taxpayer received no actual payments from the subsidiaries. The effect of these accounting entries is an increase in the overall assets of the taxpayer through an increase in its investment in subsidiaries.

The business and occupation tax is measured by the gross income of the business. RCW 82.04.220. The 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, discount, rents, royalties, fees, commissions, dividends, and other emoluments however designated . . .

RCW 82.04.080 (Underscoring ours.)

[2] Here, the taxpayer was in the business of providing services to its subsidiaries. It billed the subsidiaries for these services. The billings were cancelled and at the same time the taxpayer's investment in the subsidiaries increased by the amount of the billings. The increase in investment is an increase in the taxpayer's assets. We view this as "other emoluments however designated" which the taxpayer received by reason of engaging in business. These amounts meet the definition of gross income of the business and are subject to business and occupation tax.

The taxpayer's petition will be denied on this issue.

3. RCW 82.04.4281 (formerly codified as RCW 82.04.430(1)) provides 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.

The taxpayer believes that the following types of interest income, upon which tax was assessed, are entitled to the deduction:

- a. . . . Escrow Account (purchase of treasury stock)
- b. . . . Hotel Note (assumption of a note)
- c. . . . Debentures (convertible debentures)
- d. . . . Bonds
- e. . . . Business Tax Refund
- f. Outside Lawyer's Trust Account
- g. Swing Loans

In Determination No. 83-95, issued to this taxpayer for an earlier audit period, interest income derived from sources a, b, and c was determined to be entitled to the deduction. The taxpayer derived the interest from the investment of surplus funds and was not engaging in a financial business in doing so. We adopt that holding for this Determination. For the same reasons, the interest from . . . bonds is not subject to tax.

Interest from the tax refund and the lawyer's trust account is not taxable because it is not derived from any business activity engaged in by the taxpayer.

[3] Interest from the swing loans, however, is taxable. Swing loans involve loans to employees who are being transferred. The loans help them with various expenses associated with moving. As stated in Determination No. 83-95 interest derived from loans is not entitled to the deduction. The loaning of money is a financial business and for that reason the interest derived therefrom is taxable.

The taxpayer's petition will be granted on this item except as to interest from swing loans.

[ABC] Marketing Company

1. The income in question was received from subsidiaries, affiliates, and non-affiliated hotel companies in response to billings from the taxpayer. The billings were sent to recover part of the taxpayer's cost of operating its Central Reservation Office in [another state]. The taxpayer's computerized reservation system, [X] , is linked to several airline reservations systems, including [Y]. Some reservation requests, while processed by [X] and the Central Reservation Office, are made through [Y]. In those instances [Y] bills the taxpayer for its costs. In turn, the taxpayer rebills its customers for those costs, plus a mark-up. The only activities taking place in Washington are accounting and billing by the taxpayer.

The audit staff took the position that the taxpayer itself performed no activity outside the state and the entire amount billed was subject to tax. Everything that happened outside the state was performed by [Y] and could not be attributed to the taxpayer.

The taxpayer, on the other hand, asserts that the entire activity for which it billed took place outside of Washington. Therefore none of the income is subject to tax.

[4] In our view, the income in question is derived from activities conducted both inside and outside the state by the taxpayer. Outside the state, the Central Reservation Office . . . participates in those reservation activities with [Y] for which it is billed. If the Central Reservation Office did not participate, there would be no service which [Y] could bill for. Inside the state the taxpayer engaged in accounting activities. While accounting is not the same thing as making hotel reservations it is a necessary function without which the service would not be provided.

When offices both inside and outside the state contribute to an activity taxable under the Service classification of the business and occupation tax the income from that activity is apportionable. RCW 82.04.460 and WAC 458-20-194. This activity is taxable under that classification.

WAC 458-20-194 states in part:

Persons engaged in a business taxable under the service and other business activities classification and who maintain places of business both inside and outside this state which contribute to the performance of a service, shall apportion to this state that portion of gross income derived from services rendered by them in this state. Where it is not practical to determine such apportionment by separate accounting methods, the taxpayer shall apportion to this state that proportion of total income which the cost of doing business within this state bears to the total cost of doing business both within and without this state.

The taxpayer's citation of ETB 133.04.194 is inapposite. The ETB deals with the taxability of sales of goods taxable under Retailing or Wholesaling, not with a service taxable activity.

This matter will be referred back to the audit staff for apportionment as provided in WAC 458-20-194.

2. The taxpayer testified that \$. . . was paid to an out-of-state printer for hotel facilities directories which the printer shipped directly to out-of-state locations.

If this was in fact the case the \$. . . should not have been part of the use tax computation because the directories were never used in Washington. Evidence was provided that the directories were printed outside of Washington. However, there was no proof of where the directories were shipped.

The taxpayer will be given the opportunity to provide verification to the audit staff that the directories were never in Washington. If the audit staff is satisfied that that was the case, the \$. . . will be removed from the use tax computation.

3. Apparently, in computing the proportion of income that was subject to apportionment the audit staff did not include media advertising costs incurred outside of Washington as part of the total cost of doing business. This is a factual matter which will be referred back to the audit staff for appropriate adjustment.

DECISION AND DISPOSITION:

[ABC] Hotel Company

1. Petition granted subject to verification by audit staff.
2. Petition denied.
3. Petition denied as to swing loans. Petition granted as to other items.

[ABC] Marketing Company

1. Petition granted in part. Referred back to audit staff for apportionment.
2. Petition granted subject to verification by audit staff.
3. Referred back to audit staff.

DATED this 18th day of November 1987.