Cite as 4 WTD 341 (1987)

BEFORE THE DIRECTOR
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

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| In the Matter of the Petition | ) | F I N A L |
| For Correction of Assessment of | ) | D E T E R M I N A T I O N |
| | ) | |
| | ) | No. 86-309A |
| | ) | |
| . . . | ) | Registration No. . . . |
| | ) | |
| | ) | |
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[1] **RULE 109, RCW 82.04.080, RCW 82.04.220:** B&O TAX -- GROSS INCOME -- BUSINESS ACTIVITY -- VALUE PROCEEDING OR ACCRUING -- INTEREST -- USE OF MONEY -- MONEY MANAGEMENT -- FINANCIAL BUSINESS. Cost control accounting by a parent corporation which reflects "interest" accruals related to internal, centralized money management systems through which money is routinely transferred back and forth between the parent and its wholly owned subsidiary corporations does not result in value proceeding or accruing to the parent where the booked "interest" is not paid and is not an enforceable obligation. Centralized money management between parent and subsidiary companies does not constitute financial business which derives taxable gross receipts.

[2] **RULE 109 AND RCW 82.04.4281:** B&O TAX -- EXEMPTION -- "FINANCIAL BUSINESS" -- USE OF MONEY AS SUCH. The centralized management of corporate funds between a parent corporation and its wholly owned subsidiary companies constitutes the "use of money as such" by a person not otherwise engaged in a "financial business." Booked amounts which represent interest expense connected with such established money management activities, when paid, are exempt of b&o tax.

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

HEARING CONDUCTED BY DIRECTOR'S DESIGNEES:
Sandi Swarthout, Assistant Director
Garry G. Fujita, Assistant Director
Edward L. Faker, Sr. Administrative Law Judge

DATE AND PLACE OF HEARING: April 29, 1987, Olympia, Washington

NATURE OF ACTION:

The taxpayer appeals from the findings and conclusions of Determination No. 86-309 which was issued on December 5, 1986, following an original hearing conducted on August 15, 1986. That Determination sustained the assessment of business and occupation tax under the Service classification measured by amounts entered on the taxpayer's books of account and designated as "interest," derived from providing daily operating funds to the taxpayer's wholly owned subsidiary companies.

FACTS AND ISSUES:

Faker, Sr. A.L.J. -- The facts of this case are not in dispute. They, together with the audit and tax assessment details of the case, are fully and properly reported in Determination 86-309 and are not restated herein. The operative facts are included below only as necessary to explain the taxpayer's testimony and arguments and to circumscribe the ruling in this Final Determination.

There is a single, complex issue for our resolution. Are amounts which the taxpayer, parent company, enters upon its books as "interest," and which are calculated upon daily advances or disbursements of operating funds to the accounts of wholly owned subsidiary companies, subject to business and occupation tax? Conversely, are such amounts exempt of b&o tax under the provisions of RCW 82.04.4281 as amounts derived from investments or the use of money as such by qualifying persons?

TAXPAYER'S EXCEPTIONS:

The taxpayer asserts that it received no actual payments of interest from its subsidiary companies, nor was any such interest actually earned. Rather, interest calculations were made and entered on the taxpayer's books of account merely as an internal cost accounting control, for use as a measuring method to determine the efficiency of its subsidiary companies' use of operating funds. The taxpayer argues that the Department's assessment of tax resulted from imputing interest income to the taxpayer which was neither earned nor received. It cites the Washington Supreme Court decision in Weyerhaeuser Co. v. Revenue, 106 Wn.2d 557 (1986), for the proposition that the state may not tax "imputed interest."

Alternatively, and more aggressively asserted, the taxpayer argues that its system of internal corporate money management does not result in the occurrence of any taxable event. The taxpayer relies upon the provisions of WAC 458-20-197 (Rule 197) which, the taxpayer argues, provides that there must be the actual receipt of some value (interest) or the legal entitlement to receive some value in the amount of consideration agreed upon, before a taxable event occurs. In this case, the taxpayer asserts, it is not entitled to receive any interest payment nor has it agreed with its subsidiary companies for the payment of any consideration by them in respect to the internal money management system by which the taxpayer centrally provides operating funds and centrally collects operating income from its subsidiaries on a daily basis. This system is accomplished through a network of banking accounts through which the taxpayer clean-sweeps all subsidiary accounts for the sole purpose of fiscal efficiency and to assure that its own funding is available when and where it is most efficiently useful for purchasing, investment, or other business reasons. No actual loans are transacted; no notes or other evidences of any indebtedness are executed; no interest obligations or rates are agreed upon or secured; and no legally enforceable relationship is created between the taxpayer and its wholly owned subsidiaries. Rather, the taxpayer merely manages the flow of corporate funds and maintains cost control records to determine how efficiently the family of corporate entities is operating. The internal, "interest" account is simply useful to determine the fiscal viability of subsidiary companies and to measure internal efficiencies of scale so that year-end bonuses to subsidiaries, etc., may be determined and calculated.

The taxpayer stresses that it is not primarily engaged in any "financial business" merely because it performs the corporate money management functions of its own businesses. It does not offer money management services to any others and is not licensed, organized, or equipped to do so. It is not regularly engaged in making financial transactions or performing financial services for anyone, including its own subsidiaries. The taxpayer cites the decision in Sellen Construction Co. v. Revenue, 87 Wn.2d 878 (1976) for its position that it is not a "financial business" nor is it engaged in any "financial business" activity which is taxable. Thus, the taxpayer asserts, it needs no express statutory deduction or exemption upon which to rely for excluding imputed amounts falsely attributed to activities which do not constitute taxable business activities in the first place.

Moreover, if the Department rules that the "interest" calculations entered on its books for internal cost control purposes actually constitutes income from using its money, the taxpayer claims entitlement to the tax exemption of RCW 82.04.4281. The Sellen case, supra, is again cited as supporting the exempt status of persons in such cases. The taxpayer also relies upon the decision of the Thurston County Superior Court (unappealed) in Howard S. Wright Construction Company and Schucart Industrial Contractors, Inc. v. Revenue, No. 79-2-01310-0 (May 21, 1981). This case, dealing with periodic loans to affiliate companies is referenced as being particularly relevent. Just as in this cited case, the taxpayer stresses that the booked interest attributable to advances or "floats" provided to its subsidiaries averaged only 2.3% of its gross receipts from all business activities over the four year audit period. Also, the source of the funding made available to subsidiaries was the taxpayer's own surplus operating capital and the sale of common stock and convertible bonds.

The taxpayer distinguishes its situation from that reported in Rainier Bancorporation v. Revenue, 96 Wn.2d 669 (1982), which was relied upon, in part, by the Department in sustaining the tax. The taxpayer notes that in the Rainier Banc. case the funds loaned to affiliates were borrowed from outside sources, the interest income amounted to a substantial portion of gross income (41% to 58%), and that taxpayer was a bank holding company (an obvious financial entity) with no operating divisions. The taxpayer stresses that it is primarily if not exclusively engaged in research, development, and manufacturing of aerospace and telecommunication products, not "financial businesses."

## DISCUSSION:

The Department presently has under consideration several appeals of tax assessments involving corporate money management arrangements similar in nature to the taxpayer's in this case. Thus, some background discussion is appropriate for proper perspective. The more recent technological advances within the financial and banking industries have made possible the instantaneous electronic movement of funds between related accounts which enables the sophisticated and highly efficient methods of managing business capital to achieve the most beneficial availability and use of such funds. Thus, by various methods of assuring these efficiencies, many vertically integrated business organizations have developed internal control networks for daily money movement between their respective subsidiary and affiliate entities. Such centralized money management techniques generally involve the daily funding of operating subsidiaries by the parent or managing entity and the end of day sweeping of all subsidiary accounts down to a zero or minimum targeted balance. Banks and other financial institutions have developed and marketed such programs which they will manage for a fee. Banking officials have testified before the Department that these money management systems, even when internally managed by the businesses themselves, are not in competition with banks but are in cooperation with banks. The systems are driven by their own business dynamics rather than by the traditional concept of investing funds for a direct anticipated yield. Yet, traditional cost accounting methods are still employed in connection with these money management systems. Thus, the daily transactions are characterized with the features of loans from the parent or central account to the subsidiary accounts, even to the extent that interest is computed and booked on the records of the parent or central account. This, we are advised, accomplishes a true efficiency measurement of the use of all operating funds. In short, interest expense is computed to derive a true picture of how profitably any operating subsidiary has performed. It tells the business managers what the daily profit/loss status of all funded subsidiary or affiliate entities would be if they were required to procure funding at arm's length in the financial marketplace, and pay a cost for such operating funds. However, we are also advised that no such cost of money is actually charged or paid. Rather, interest costs are imputed, at best. They are neither required to be recorded on the books of account of the parent or managing entity, nor to be reported as actual income for any purpose. The interest computations are exclusively performed for internal, informational, control purposes.

In respect to other appeal cases pending, the Department has reviewed money management service programs of this kind packaged and sold by banks which have appeared and testified in an amicus capacity. Though they are modified to meet the needs of different customers, these programs are identical in purpose and effect with the system explained by the taxpayer in the case before us here. All appellants in these cases have asserted that these money management systems serve to stimulate the state's economy. From a tax policy administration standpoint, they assert, the correct recognition by the Department that these electronic and internal accounting devices do not constitute loans or actual interest income producing transactions will enhance the business climate in this state and further encourage business sitings here. In fact, two of the persons seeking our ruling on this same question are businesses which have not yet entered this state with their money management functions, pending the outcome of this inquiry.

[1] Turning to the case before us here, we have thoroughly reviewed the taxpayer's pertinent records and its system of internal money management. We have also thoroughly researched the case law cited in support of the taxpayer's positions. Though no case cited was precisely on point, the rationale of the courts is insightful and guiding in our deliberations. Most specifically, the decision in Wright/Schucart, supra, is distinguishable because it concerned outright loans to subsidiary companies which bore actual principal repayment and interest obligations, evidenced by executed loan documents. Moreover, as explained in Determination 86-309, the primary source of funds loaned to affiliates in Wright/Schucart was third party banks rather than operating fund surpluses. The Weyerhaeuser, supra, case involved interest imputed from conditional sales contracts for standing timber sales rather than loans or advances of operating funds to subsidiaries. The Sellen Construction, supra, case involved no loans or funding advances, but dealt only with the passive investments of surplus funds in traditional income producing markets (stocks, bonds, money market accounts, etc.). The very limited ruling in Rainier Bancorporation, supra, concerned only a holding company of institutions which were clearly "financial businesses" by definition. All of these cases are distinguishable. Whether the distinctions are of substantive meaning or are merely factual is a moot question. Nonetheless, none of these cases is dispositive of the question before us here. Instead, the issue turns upon the direct statements of statutory law and the tax policy inherent in the administration of those statutory prescriptions.

RCW 82.04.140 defines the term "business" to include:

> . . . all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or to another person or class, directly or indirectly.

Under this definition, money management functions clearly constitute "business."

RCW 82.04.150 defines "engaging in business" in the simplest manner as ". . . commencing, conducting, or continuing in business and also the exercise of corporate or franchise powers . . . ."

Clearly, the taxpayer engages in business and exercises corporate powers when it manages corporate funds.

RCW 82.04.030 defines the terms "person" and "company" to be used interchangeably, and to mean,

> . . . any individual, receiver, administrator, executor, assignee, trustee in bankruptcy, trust, estate, firm copartnership, joint venture, club, company, joint stock company, business trust, municipal corporation, political subdivision of the state of Washington, corporation, association, society, or any group of individuals acting as a unit, whether mutual, cooperative, fraternal, nonprofit, or otherwise and the United States or any instrumentality thereof.

Neither the taxpayer in this case nor any of those in the other cases of this kind on appeal before the Department, argues that the subsidiaries are not separate persons or seeks to have us disregard their corporate separateness.

RCW 82.04.080 defines "gross income of the business" as,

> . . . the <u>value proceeding or accruing by reason of the transaction of the business engaged in</u> 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, all without any deduction on account of the cost of tangible property 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. (Emphasis supplied.)

Within the scope and intent of the foregoing statutory definitions, it is clear that a "person" may engage in "business" without any "value proceeding or accruing" by reason of the "transaction" of that business.

RCW 82.04.220 imposes the business and occupation tax as follows:

> There is levied and shall be collected from every person a tax for the act or privilege of engaging in business activities. Such tax shall be measured by the application of rates against value of products, gross proceeds of sales, or gross income of the business, as the case may be.

Thus, business and occupation tax is only imposed when the transaction of business activities results in gross income--i.e., values proceeding or accruing.

In its administration of these statutes the Department of Revenue recognizes, as a matter of both statutory construction and tax policy, that much business is transacted without incurring business tax liability. In such cases it is not necessary to apply statutory tax exemptions because the activity derives no income to tax. Many integral business activities necessary to the on-going functioning of a business enterprise are routinely performed by the business entity itself, without incurring tax liability, even though these same activities would incur tax liability when procured and paid for in the competitive marketplace. The meaningful question is, then, does the taxpayer's activity of marshalling the profits and losses incurred by its subsidiaries, through the application of internal money management techniques, derive additional, taxable value proceeding or accruing? In our view it does not, for two distinct and independently dispositive reasons.

First, the money management techniques do not result in any actual payments or receipts to the taxpayer. In its simplest sense, these activities merely result in moving already taxed money from one pocket to another. No fee is charged and no consideration or value is actually received for this function.

The cost accounting control achieved by computing the expense of this money movement, designated as "interest" or by any other name, is simply a bookkeeping device. As in the case before us here, there is no evidence of any payment or legally enforceable obligation to pay the computed interest expense. Thus, as a finding of fact, the taxpayer has not received interest income from these money management activities. The court's general rationale in Weyerhaeuser, supra, supports this position.

[2] Second, even if, arguendo, the expense of money management computed and designated as "interest" were deemed to result in value proceeding or accruing to the taxpayer, the specific tax exemption of RCW 82.04.4281 would apply.

The exemption statute provides in pertinent part 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 . . .

Under this statute there are two criteria for exemption. (a) The amounts must be derived from "investments or the use of money as such," and (b) the recipient of such amounts must not be a "financial business." Both criteria are satisfied in this case. Our analysis of the money management technique employed by the taxpayer and explained earlier herein reveals that it is simply the "use of money as such." It does not constitute the making of loans or other investments in any traditional sense, nor is it supported by any of the legal evidences of rights and obligations flowing between the taxpayer and its subsidiaries. Rather, it is precisely the kind of marshalling of assets which is contemplated by the statutory language, "use of money as such."

Moreover, business entities do not assume the characteristics or functions of "financial businesses" comparable to banks, loan companies, or investment companies, merely by virtue of performing internal fiscal functions. All businesses perform fiscal functions. All businesses assumably arrange and marshall their own financial affairs in such a manner as to achieve maximum cost and funding efficiencies. The degree of sophistication of such money management enabled by electronic banking technologies does not dictate tax liability under Washington State laws. Performing such functions for one's self neither constitutes engaging in "financial business," nor makes the performing entity a "financial business" by nature. Rather, it is an internalized, incidental function of any business enterprise and is not the taxable business activity in which it is primarily engaged. This is the cumulative rationale of the courts' decisions in the Sellen and Wright/Schucart cases, supra, even though those decisions are not precisely on point with the taxpayer's case here.

Finally, we recognize that identifying the features of money management activities to distinguish them from taxable financial business transactions is difficult at best. The accounting principles employed and records entries made can be unintentionally deceptive. Furthermore, we do not possess the technical expertise to clearly define all of the characteristics of money management methods, especially in a rapidly changing area of electronic technological evolution. In other cases pending appeal before the Department sample programs developed by banks have been submitted for our examination. These programs are now matters of public domain. The basic features and purposes of one such program have been selected and attached to this Final Determination as Exhibit A.[1] Clearly, and unarguably, when programs such as these are marketed or their functions are performed for a fee or charge, that income is taxable under the Service b&o tax classification. This is true even when the business organization itself performs these activities for its subsidiaries if a charge for that service is made. Moreover, our ruling in this case is limited and must be applied only for money management activities as opposed to other arm's length financial dealings between closely related but separate business persons. The latter activities which generate "gross income" are taxable just as if no close relationship existed between the persons. The Department's position with respect to amounts derived from outright, interest bearing loans between parent and subsidiary companies and other financial transactions from which value proceeds or accrues to a taxpayer remains unchanged. See ETB 505.04.109.

DECISION AND DISPOSITION:

The taxpayer's petition is sustained. Tax Assessment No. . . . will be amended to delete Service business and occupation tax on "interest" accruals contained in Schedule II of the

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[1] Though we have procured permission to reprint excerpts of this program in this Final Determination, all references to its source have been deleted.

audit. The balance of the assessment, if any, will be due for payment in full on the due date to be shown on the amended assessment.

DATED this 16th day of December 1987.

See hardcopy for attachment