BEFORE THE INTERPRETATION AND APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition	)	D E T E R M I N A T I O N
For Correction of Assessment of	)	
	)	No. 89-331
	)	
[Taxpayer I]	)	Registration No. . . .
	)	Document No. . . .
	)	
and	)	
	)	
[Taxpayer II]	)	Registration No. . . .
	)	Document No. . . .
	)	

[1] RULE 203: B&O TAX -- RETAIL SALES TAX -- SEPARATE PERSONS -- COMMONLY-OWNED BUSINESS ENTITIES. The Washington Revenue Act makes no provision for the disregard of transactions between a sole proprietorship and corporation, even though they may share common ownership by a single individual.

[2] MISCELLANEOUS: B&O TAX -- RETAIL SALES TAX -- CORPORATE REORGANIZATION -- DISREGARD OF INTERCOMPANY LEASE -- SUBSTANCE OVER FORM. The doctrine of substance over form is not generally available to a taxpayer to eliminate the tax consequences of the taxpayer's chosen form of the transaction. Accord: 85-112A, 1 WTD 343 (1986).

[3] RULE 106: RETAIL SALES TAX -- EXEMPTION -- "ADJUSTMENT IN THE BENEFICIAL INTEREST" -- RELATED BUSINESS ENTITIES -- LEASE OF TANGIBLE PERSONAL PROPERTY. An outright lease of tangible personal property from one business entity to another related business entity is not a transfer of a capital asset under the "adjustment in the beneficial interest" provisions of WAC 458-20-106. There is no transfer

of assets in return for an adjustment in the beneficial interest in a business.

[4] RULE 106: B&O TAX -- CASUAL OR ISOLATED -- LEASING ACTIVITY -- SOLE BUSINESS CONDUCTED. When a taxpayer's only activity is the leasing of capital assets, that activity is not "casual or isolated."

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 CONFERENCE: December 17, 1985

NATURE OF ACTION:

Related taxpayers petition for the cancellation of B&O and retail sales tax assessments attributable to the lease between them of capital assets.

FACTS:

Bauer, A.L.J. (successor to Chandler, A.L.J.) -- Taxpayer I, a sole proprietorship originally formed to operate a . . . store, was audited by the Department of Revenue for the period July 1, 1981 through March 31, 1985. As a result, the above-referenced tax assessment was issued in the amount of $ . . . .

Taxpayer II, a corporation formed to continue the same grocery business, and owned by the same marital community as the side proprietorship, was audited by the Department of Revenue for the period July 1, 1981 through March 31, 1985. As a result, the above-referenced tax assessment was issued in the amount of $ . . . .

The taxpayers have each appealed the assessments. The related appeals have been consolidated.

The essential facts as related by the taxpayer and as revealed by the taxpayers' files are as follows:

Taxpayer I was the initial owner and operator of a . . . grocery store, which opened on January 23, 1980. Taxpayer I acquired the inventory, fixtures, and equipment necessary for its operation, and retail sales and use taxes were paid on these items.

A sole proprietorship was selected as Taxpayer I's form of doing business so that anticipated early losses in the business could be offset against other income of the marital community for Federal tax purposes. However, the marital community planned from the outset to incorporate as soon as the business became profitable. It was never anticipated that the business would continue to be operated as a sole proprietorship.

In June 1981, Taxpayer II's Articles of Incorporation were filed, and all assets (with the exception of the fixtures and equipment) of Taxpayer I were transferred to Taxpayer II as an initial contribution to capital. Taxpayer I (i.e., the marital community) received 1,000 shares of stock ($1.00 par value) and a ten-year interest bearing promissory note for $3,848. Taxpayer I closed its account with the Department of Revenue on July 1, 1981.

Title to the fixtures and equipment was retained by Taxpayer I, but nothing else changed with respect to the operation of the . . . store. A lease (rental agreement) was entered into on September 22, 1981 for Taxpayer II's use of the fixtures and equipment from July 1, 1981 through June 30, 1983. The agreement further provided that the fixtures would be surrendered to the lessor in good condition at the end of the lease term.

Taxpayer II made regular monthly payments of $13,062.50 to Taxpayer I from July 1, 1981 through June 30, 1983, and payments of $12,250 per month from July 1, 1983 through March 31, 1985. These payments were shown as rental payments in the books of both taxpayers. A substantial portion of these rental payments were used by Taxpayer I to pay the outstanding debts on the fixtures and equipment. Taxpayer I filed no returns and paid no taxes to the Department of Revenue on rental payments received.

On audit, the Department reopened the Taxpayer I's account and assessed sales and business and occupation taxes totalling $. . . (including interest) on the lease payments. The Department also assessed use taxes against Taxpayer II based on the same rental payments, which assessment totalled $ . . . (including interest). It was the auditor's position that either sales tax was owed by Taxpayer I, or use tax was owed by Taxpayer II, and that once the sales/use tax liability was satisfied by one taxpayer, the assessment against the other taxpayer will be cancelled.

ISSUES:

The taxpayers generally take the position that Taxpayer I discharged its tax liability by payment of the sales tax upon acquiring the fixtures and equipment, and that the transaction involving the formation of Taxpayer II and the subsequent lease agreement created no tax liability.

The taxpayers have raised three specific issues for our consideration:

1. Whether the existence of separate business entities, and a lease transaction between them, should have been disregarded for tax purposes under the following circumstances:

a. A business operated by a sole proprietorship was incorporated by the owners, but title to certain fixtures and equipment was retained by the sole proprietorship for lease to the new corporation solely to obtain federal tax benefits,

b. Monthly lease payments were made by the corporation in an amount in excess of the sole proprietorship's debt payments (in order to provide an extra payment to the sole proprietorship not subject to payroll taxes),

c. The business conducted before and after incorporation was identical,

d. The beneficial ownership of the business, viewed as a whole, remained the same, since the corporation and sole proprietorship were both owned by the same marital community, and

e. The fixtures and equipment could have been transferred tax-free from the sole proprietorship to the corporation without any Washington excise tax consequences.

2. Whether the lease described in paragraph 1 was a tax-exempt casual or isolated sale under WAC 458-20-106.

3. Whether the lease described in paragraph 1 constituted an adjustment of beneficial interests of the business under WAC 458-20-106 (or, as the taxpayer claims, a "simple restructuring of the flow of money which came about because of

the change in beneficial interests in the reorganized business"), and therefore did not constitute a taxable transaction.

DISCUSSION:

[1] As to the first issue, the taxpayers would have the Department disregard the fact that they were two separate business entities, and treat both of them as one consolidated business entity. It is then argued that the lease income is not really income to the "business" as a whole, since both the sole proprietorship and the corporation are wholely owned by the same marital community.

It is well established that, for Washington excise tax purposes, charges against or income derived from corporate 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. 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."

[2] Likewise, the Washington Revenue Act makes no provision for the disregard of transactions between a sole proprietorship and corporation, even though they may share common ownership by a single individual.

As to the taxpayers' argument that because the fixtures and equipment could have been transferred tax-free to the corporation, the Department should disregard the form of the lease transaction and recognize the transaction as a corporate reorganization, we must also disagree.

Taxpayer I, for reasons satisfactory to itself, voluntarily chose to maintain ownership of the business's fixtures and equipment in the sole proprietorship, and lease these items to Taxpayer II. Having elected to do business in this manner for the benefits it offered, it must also accept the disadvantages. The taxpayer cannot have it both ways.

Were the Department to disregard Washington taxpayers' chosen forms and methodologies of doing business, the predictability of the effect of their legal declarations would be seriously eroded. Were the Department to follow this line of reasoning, the administration of the tax laws would not be predictable, and each taxpayer's assessment would have to be determined by what the taxpayer "really meant" or "could have been done" rather than what was actually done.

Thus, the Department's policy is to limit taxpayers' use of elevating substance over form.

The taxpayers in this case were free to choose the form of business which they desired, and there is no reason now, other than to escape the clutches of the Washington tax collector, to disregard that form. The availability of the "substance over form" analysis is generally limited to use by the Department when it believes that transactions may be sham and lack economic reality. To allow taxpayers to elevate what they believe to be substance over form would make predictable tax administration nearly impossible, and will thus not be permitted.

[3] Further, the "adjustment in the beneficial interest" provisions of WAC 458-20-106 clearly do not apply to the lease transaction in question, since the lease agreement did not transfer an ownership interest in the fixtures and equipment from Taxpayer I to Taxpayer II. An outright lease of tangible personal property from one business entity to another related business entity is not a transfer of a capital asset under the "adjustment in the beneficial interest" provisions of WAC 458-20-106. There is no transfer of assets in return for an adjustment in the beneficial interest in a business. The rule is inapposite on its face.

[4] Nor are we persuaded that the lease in question was a "casual or isolated sale" under WAC 458-20-106. RCW 82.04.040 defines "casual or isolated sale" as

a sale made by a person who is not engaged in the business of selling the type of property involved. Any sales which are routine and continuous must be considered to be an integral part of the business operation and are not casual or isolated sales.

The only business activity conducted by Taxpayer I subsequent to June 1981 and during the audit period was the leasing activity at issue. Thus, the leasing activity was neither casual nor isolated from any other isolated business regularly conducted.

Thus, the business and occupation and retail sales taxes assessed against Taxpayer I are upheld. Since the use tax applies upon the use of any property purchased at a retail sale without payment of use tax (even if "casual or isolated"), the use tax assessment against Taxpayer II is also upheld. If Taxpayer I's retail sales tax assessment is paid, Taxpayer II's use tax assessment will be cancelled, or vice versa.

DECISION AND DISPOSITION:

The taxpayers' petitions are denied. . . . .

DATED this 23rd day of June 1989.