

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 Refund of)
) No. 89-290
)
) Registration No. . . .
) . . . /Audit No. . . .
)

[1] RULE 224: SERVICE B&O TAX -- AMOUNTS SHOWN ON BOOKS AS INTEREST -- AMOUNTS PAID TO JOINT VENTURER -- CONTRIBUTIONS TO CAPITAL -- DEBT V. EQUITY. Where a joint venturer advances money to a joint venture, but the repayment is contingent on profitability of the enterprise, the amounts advanced by the venturer are a capital contribution and not debt. Amounts paid to the venturer are a preferred return on a sale of real property and are not subject to tax.

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: January 10, 1989

NATURE OF ACTION:

Taxpayer protests the imposition of Service business and occupation tax on amounts it claims are advances to a joint venture.

FACTS AND ISSUES:

Hesselholt, A.L.J. -- Taxpayer is a subsidiary corporation of It is in the business of purchasing raw land which it develops for sale to home builders. In order to do this, taxpayer enters into joint venture agreements with another party. Taxpayer advances funds to the joint venture,

purchases and holds the property in its own name, contracts and pays for all the necessary labor and materials, and carries out the development of the property. The other party in the joint venture assists in rezoning and marketing the developed property.

According to the joint venture agreements, taxpayer can either advance or loan money to the venture. Any funds advanced by taxpayer to the project are repaid before profits are distributed and accumulate "interest" charges. Distributions from the joint venture go first to obligations of the joint venture, then to repay advances, then to pay "interest" on advances, and profits remaining are split 50-50 between the venturers. The funds advanced by the taxpayer to the venture were its own funds, and no payments were made until the property was sold. At that time, the advanced funds were paid back, with the "interest", and then the profits were divided between the joint venturers. If the property did not realize a profit, the funds were repaid to the extent possible. Although taxpayer showed interest accruing on its books, no interest was ever actually paid until the property was sold and the profits, if any, were divided. Taxpayer reported this "interest" on its federal tax returns as income from lot sales, not as interest income.

Taxpayer's records were audited by the Department of Revenue for the period January 1, 1984 through September 30, 1987. As a result of the audit, an assessment was issued for the amount of \$. . . , which the taxpayer paid in full. Taxpayer petitioned for a refund of the service tax assessed by the auditor on the "interest" income described above. The auditor taxed the interest because he found that the payment of interest was "absolute and completely divorced from the distribution of profits, and therefore, the interest accrued becomes taxable . . . "

DISCUSSION:

[1] The business and occupation tax is imposed on any person engaging in business in the state of Washington. "Business" is defined as

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

RCW 82.04.140. Exceptions to the tax are statutorily authorized. One is provided by RCW 82.04.390 as follows:

This chapter shall not apply to gross proceeds derived from the sale of real estate. This however, shall not be construed to allow a deduction of amounts received as commissions from the sale of real estate, nor as fees, handling charges, discounts, interest or similar financial charges resulting from, or relating to, real estate transactions.

Interest for the use of money is "the compensation allowed by law or fixed by the parties for the use or forbearance or detention of money." Black's Law Dictionary, 5th Edition, 1979. Income is defined as "the return in money from one's business, labor, or capital invested; gains, profits, salary, wages, etc." Black's. All income from investments is, to some extent, compensation for the use of money.

The taxpayer has argued that the amounts shown as interest on its books are not interest, but are actually a preferred return from the eventual sale of real estate. Taxpayer argues that it did not loan the funds to the joint venture, but instead made advances of capital to the joint venture. The taxpayer points out that it is a subsidiary of a bank; if it wanted to make loans, it certainly knew how to do so. No promissory notes or loan papers were ever executed between the taxpayer and the joint venture. The amounts were not paid until the property was sold. They were not treated on the federal tax return as interest, but instead were shown as income from the sale of real estate.

Distinguishing debt from equity is a problem that has long plagued the tax field.¹ The traditional approach has been to analyze all of the factors surrounding the transaction and determine whether the investment was intended as a loan or some sort of equity investment.² Determining whether a transaction was meant as debt or equity is often said to

¹See, for example, Jack M Feder, "Either a Partner or a Lender Be: Emerging Tax Issues in Real Estate Finance." 36 Tax Lawyer 191, 1986.

²Id., at 197.

depend on the "intent of the parties."³ The primary factors involved in determining whether a transaction is debt or equity are: profit or loss sharing; capital contributions; fixed payment date; intent to repay/expectation of repayment; and reasonable terms.⁴

According to the General Counsel Memorandum (GCM) supporting Revenue Ruling 76-413 (1976-2 CB 213, 214), GCM 36179, contingent interest based on gross receipts from mortgaged property does not alone disqualify such payments as interest, but contingent interest based in whole or in part on the income or profits derived from real estate does not qualify as interest for purposes of Sec. 856(c) of the Internal Revenue Code. The GCM concluded that interest based on net profits constitutes a profit-sharing arrangement. In this case, even though the "interest" is stated at a specified rate, the payment of interest is dependent on the profits derived from the property, because it is not paid out until the obligations of the joint venture are met.

Determining whether something is a capital contribution depends on whether or not it is at risk. In this case, taxpayer only receives his advance and the "interest" if the property sells at a profit. There is no fixed payment date; the payment is made when the property is sold. The intent to repay/expectation of repayment is high. The reasonableness of the terms is determined by whether or not an unrelated third party would have given the joint venture the same terms. In this case, while an unrelated third party might have agreed to the same rate, we think it highly unlikely that such a party would have been willing to forgo all interest and principal payments until the property was sold, and would have failed to complete any paperwork indicating that the transaction was a loan.

The auditor believed that the payments were interest, absolute, and therefore taxable. An "absolute" payment right is one that is "without relation to or dependence on other things or persons." Black's Law Dictionary, Fifth Edition, 1979. In order to have an absolute right to payment, there must be no dependence on the existence of a profit or sale. If the taxpayer had had a right to have the amounts paid as

³C. Nachmias & J. Nasuti, Joint Ventures: Structuring Alternatives 5-2, (Tax and Estate Planning Series, 1988).

⁴Id., 5-4.

interest on a regular basis regardless of whether the land was sold or sold at a profit, then it would have had an absolute right to the interest payments. Since the payments were dependent on the sale of the property and the existence of a profit, it had no absolute right to payment.

Balancing all of these factors, the amounts taxpayer advanced to the joint venture seem to be more characteristic of an equity investment than a loan. As an equity investment, the return is not strictly an interest payment, but is instead a return from the sale of the real estate.

DECISION AND DISPOSITION:

Taxpayer's petition is granted. The file shall be returned to the Audit Section so that a refund may be issued.

DATED this 30th day of May 1989.