Cite as Det. No. 00-080, 20 WTD 204 (2001)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 00-080
. . .	)	Registration No. . . .
	)	FY. . ./Audit No. . . .

[1] RULE 179; RCW 82.16.010(12): PUBLIC UTILITY TAX -- SERVICE CHARGES -- CAPITAL FACILITIES -- BONDED INDEBTEDNESS. Amounts attributable to capital construction and reduction of bonded indebtedness contained in services charges are not deductible from gross receipts of utility districts, although amounts received by the utility for extending new service to customers or additional service to existing customers at different locations are deductible. Citing *Kennewick v. State*, 67 Wn.2d 589, 409 P.2d 128 (1965).

[2] RULE 179; RCW 82.04.417: PUBLIC UTILITY TAX -- REPEAL OF EXEMPTION -- SERVICE CHARGES -- CONTRIBUTIONS IN AID -- CAPITAL FACILITIES -- BONDED INDEBTEDNESS. Repeal of RCW 82.04.417 withdrew the authority for Det. No. 80-451, 98 WTD 195 (1985).

[3] RULE 100; RCW 82.32.105(3); RCW 34.05.010(1); RCW 34.05.410-588: WAIVER OF INTEREST -- AMINISTRATIVE PROCEDURES ACT -- ADJUDICATIVE PROCEEDINGS -- UNREASONABLE DELAY. The Department is not required to waive interest because the hearing before the Appeals Division did not take place within six months of the date of filing. Hearings before the Appeals Division of the Department of Revenue are not adjudicative proceedings under the APA. Such hearings do not arise from a statute requiring a hearing or a constitutional right. The Department does waive interest beyond 12 months where the sole reason for the delay was for the benefit of the Department.

NATURE OF ACTION:

Bianchi, A.L.J. -- The taxpayer protests the assessment of public utility tax (PUT) on the portion of monthly service charges paid by the utility's customers that is allocated toward the payment of bonds issued for capital facilities construction.[1]

BACKGROUND

The taxpayer is a public utility that purchases water from the City of . . . and distributes it to its residents through a combined water distribution and sewer system. In 1967 and 1986, the taxpayer issued capital improvement bonds to finance system-wide capital improvements, including the construction of a reservoir and extensions of and improvements to its distribution system. The taxpayer refinanced these bonds in 1997. The municipal ordinances authorizing the issuance of the bonds required the taxpayer to segregate funds from the gross revenue of the utility sufficient to pay such debt service. From the water customer's monthly payments for service, the taxpayer deducted and segregated into reserve accounts sufficient funds to pay the debt service on these bonds.

Between 1989 and July 1, 1993, a public utility was able to deduct from its gross income the amount of monthly service charges that it set aside to pay for capital facilities bond retirement, pursuant to the Aid of Construction deduction. RCW 82.04.417.

. . .

TAXPAYER'S EXCEPTIONS

The taxpayer does not dispute the effect of the repeal of RCW 82.04.417. Instead, it relies upon a line of cases issued before the Aid of Construction deduction was passed in 1969. The taxpayer argues that the right to the deduction arises from the definition of "gross income" in the public utility tax, which existed before the 1969 deduction was passed and was unaffected by its repeal. The taxpayer contends that funds segregated after receipt for the purpose of payment of capital construction costs are not income received for *the performance* of the utility business, but for the construction of the utility business. Second, the Taxpayer argues that, to the extent the caselaw creates an ambiguity about the application of the tax, the ambiguity must be resolved in favor of the taxpayer. Third, the taxpayer argues that its financing is so different from that discussed in *Kennewick v. State,* 67 Wn.2d 589, 409 P.2d 138 (1965)(hereinafter *Kennewick*) that the funds are not PUT taxable. Finally, the taxpayer contends that all the interest accruing while the case was under appeal must be waived contending both that the delay in deciding the case violates the APA and that it is fundamentally unfair to have interest accrue during the entire appeal period.

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

ISSUES

1. Is the taxpayer entitled to deduct from payments it receives from its customers for water service the amount it has allocated to payment of bonds for capital facilities?
2. Is there sufficient ambiguity as to the application of the public utility tax to such water service charges to entitle the taxpayer to the benefit of the doubt?
3. Do differences between bonds issued by the taxpayer and those discussed in *Kennewick* make the disputed income not PUT taxable?
4. Should interest be waived for the entire time this case has been on appeal because of undue delay?

DISCUSSION

This case raises again the enduring disagreement between public utilities and the Department of Revenue over the applicability of the public utility tax to the payment of construction costs. The utilities have long argued that the public utility tax does not apply to amounts received from ratepayers that are required to repay the costs, including interest, of the construction of a distribution system. Except for the period between 1989 and 1993, the Department, on the other hand, has usually contended that the public utility tax applies to all revenue collected from ratepayers for the supply of the regulated commodity. The PUT specifically prohibits the deduction of the costs of development and construction of the distribution system from the measure of the tax. For four years prior to the repeal of RCW 82.04.417, however, the Department construed that statute to allow utilities to deduct such costs even if paid through service charges under certain circumstances. Det. No. 89-451, 8 WTD 195 (1985).[2] Because that determination relied upon RCW 82.04.417 as the source of this authority, the Department has considered the statute's repeal to have ended its authority to allow the deduction.

As to the taxpayer's argument that, despite the repeal, *King County Water Dist. No.68 v. Tax Comm'n*, 58 Wn.2d 282, 362 P.2d 244 (1961)(hereinafter *King County*) and later cases should be construed to allow a deduction for income received to pay for capital facilities, we cannot agree. We are bound by the later decision in *Kennewick v. State, supra,* and deny taxpayer's petition for the reasons stated in that opinion and below.

[1], [2] **1. RCW 82.16.010(12) does not authorize the deduction of payments received for capital facilities bonds.**

[2] Whether this was the correct result need not be decided. The Aid of Construction deduction, at RCW 82.04.417, specifically excluded from the deduction revenues used for payment of capital facilities bonds that were collected as part of service charges: "Service charges shall not be included in this exemption even though used wholly or in part for capital purposes." Laws of 1969, ex. sess., ch. 156, §1. Despite the clear words of the statute, between 1989 and 1993, the Department construed RCW 82.04.417 to allow the deduction where the specific amounts of such charges to be paid for capital facilities were publicly authorized and were specifically segregated for payment of bonds. Det. No. 87-63, 2 WTD 185 (1986); Det. No. 89-451, 8 WTD 195 (1985). Because the statute these determinations construed to reach this result was repealed before the instant assessment period, the rationale of these determinations is inapplicable to this assessment.

RCW 82.16.010(12) defines gross income as:

> "Gross income" means the value proceeding or accruing from the performance of the particular public service or transportation business involved, including operations incidental thereto, but without any deduction on account of the cost of the commodity furnished or 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.

King County, supra, first addressed the question of whether payments for capital expenditures were to be included in the measure of the public utility tax. There the water district charged two existing customers for the cost of extensions of water mains to their properties, and also charged specific customers both for the cost of installing water meters at their properties and inspecting water main extensions to their properties that had not been built by the city. In each case the individual customer receiving the service paid for it. The court held that such payment was excludable from the gross income of the utility because it was received, not for providing water, but for enabling the customer to connect to the system.[3] In the same year, *Seattle v. State*, 59 Wn.2d 150, 367 P.2d 123 (1961) (hereinafter *Seattle I*) held that revenue received by a utility from prospective customers for the construction of extension facilities allowing the prospective customers to hook up to the water service were not part of the gross operating revenue received for the delivery of water. Therefore, under the principle enunciated in *King County*, supra, the funds were not received for water distribution and, hence, were not to be included in the measure of the public utility tax.

Next came *Kennewick v. State, supra.* In that case, the Supreme Court held that all monthly service charges paid by water customers were part of the gross income of the utility and, therefore, were subject to the public utility tax. More specifically, the case held that the portion of such payments the city used to repay bondholders for the costs of construction of the distribution system itself and interest was not deductible. In *Kennewick,* the Court specifically contrasted the revenue received from all Kennewick ratepayers for their water service with King County and Seattle's revenue received from a specific customer for the utility's construction of extension lines either to an existing customer's new project or to a new customer's property. *Id.* at 592-93. The latter costs were not considered to have been incurred or paid for the performance of the utility's function—the delivery of water. But the Kennewick payments were received for water service, which the Court considered revenue received for the performance of the utility.[4]

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[3] At the time of that decision the public utility tax applied to "gross operating revenues" accruing from the performance of the utility. Although the statute was later changed to remove the reference to "operating" income, the definition of gross income was not changed. No court has considered that change alone significant in deciding what income is taxable. *Kennewick*, 67 Wn.2d at 595.

[4] In addition to the holding that receipts from existing customers used to repay bonds issued for capital improvements were "operating" income subject to public utility tax, the *Kennewic*k Court also held that receipts from prospective customers for capital improvements, such as line extensions servicing that new customer, were not

Last came *Seattle v. State*, 12 Wn.App. 91, 527 P.2d 1404 (1974) (hereinafter *Seattle II*). The issue was whether income received by a utility for the costs of placing electrical wiring underground was part of the taxable operating revenue of the utility. The costs were billed either directly to the customers desiring the undergrounding or to a Local Improvement District organized for that purpose. The Court of Appeals emphasized that funds received "exclusively" for the cost of conversion from overhead to underground wiring were not operating income. *Id.* at 96. The program was undertaken by residents who desired uncluttered views, not for the distribution of electricity they didn't already have. Those payments were not part of the utility's regular charge for electric service, but were separately billed. The court held such income was not taxable, and was analogous to the charges for hook up to individual property owners that were not taxable under *King County* and *Seattle I*.

The Court of Appeals, however, went on to say:

> It is clear to this court from the statutes and from the opinion in King County Water Dist. 68 v. Tax Comm'n, supra, that the taxable "gross income" which is within the purview of RCW 82.16 must accrue from the performance of the public service, in this case the operation of a plant or system to supply electrical energy, and not from customer contributions toward the capital costs of constructing such a system, underground or otherwise.

Seattle II, 12 Wn. App. at 96 (emphasis added). The taxpayer argues that this quotation from *Seattle II* supports its contention that *Kennewick* incorrectly interpreted *King County*. *King County*, the taxpayer argues, actually stood for the principle that all funds collected for and earmarked toward capital construction were not part of gross income received for the performance of the utility's business. Taxpayer points to the following passage from *King County:*

> Constructing, installing, and inspecting facilities for the purpose of operating a plant do not constitute operations of such facilities as expressly provided for under the statutory definition. Thus it follows that money received as reimbursement for the cost of constructing, installing, and inspecting facilities for the purpose of operating a water distribution system would not be within the operation of the Water District's distribution system.

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subject to the public utility tax, but were subject to the business and occupation tax. House Bill 659, which became RCW 82.04.417, was introduced to codify the Court's ruling that the income from line extensions and hook ups was not taxable under PUT, to reverse the ruling that the line extensions and hook-ups were B&O taxable and to codify the ruling that service charges that include amounts to pay capital costs were taxable under PUT. Laws of 1969, ex. sess., ch. 156.

58 Wn.2d at 285-96 (emphasis added by taxpayer). The taxpayer also contends that nothing in the passage quoted from *King County* suggested that the Supreme Court intended to differentiate between existing customers and prospective customers.

We do not agree that the above quotations stand for the principle that a blanket deduction for all funds collected for or earmarked toward capital construction was intended by the Court in *King County*, but were misconstrued in *Kennewick*. The same justice, Justice Robert T. Hunter, wrote all three decisions, *King County*, *Seattle I* and *Kennewick*, so a misunderstanding of the holding of the earlier cases seems unlikely. Second, the argument separates the broad principle apparently enunciated in the quotation from the narrow facts of the cases. The *King County* case revolved around the construction of an extension line to benefit a specific customer that was paid for by that customer. The reference to "constructing, installing, and inspecting facilities" quoted from *King County* must be understood in light of the facts and holding of that case--that receipts for capital facilities that extend service to an individual customer are not PUT taxable. The case simply did not involve the taxability of receipts for system-wide distribution facilities.

The basic rationale of the Court in *King County* was the disputed revenue could not have been received for the performance of the utility's business because "the consideration was to qualify the parties to make them capable of purchasing water, rather than consideration for their purchase of water itself from the Water District over its distribution system." 58 Wn.2d at 287. Funds received by the taxpayer in the instant case, however, were all from customers already receiving water distribution, not from customers who were newly connected to the service either because they were new customers or connecting at a new location.

Far from clouding the issues, the Court of Appeals in *Seattle II* actually recognized that the *Kennewick* facts were far different from the undergrounding issues before it:

> [T] he City of Kennewick was essentially attempting to exclude from the public utility tax amounts that have been received by the city as a result of monthly charges made by the city to all its customers of the supply of water. The revenue received as a result of such monthly payments for services rendered is taxable gross income of the utility, pursuant to RCW 82.16, while the revenue received as a result of billing the customer for the cost of constructing a distribution system to his property is not.

Id. at 96-97 (emphasis added). The Court of Appeals also distinguished the facts of *Kennewick* from those in *King County* and *Seattle II* by pointing out that in both of the latter cases the revenue at issue arose from "bilateral transactions" between the customer and the utility for services unique to that customer, whereas in *Kennewick* it arose from the general obligation of all the utility's customers to pay for services rendered. *Id*.

King County, *Seattle I* and *Seattle II* held that gross income of a utility does not include payments for the purchase of access to a service (hook ups or extension lines) by a new customer or an old customer in a new location, or for amenities collateral to a service such as replacing overhead wiring with underground wiring. Such payments are paid in full by customers who

vote for or request the specific enhancement and are not paid by all ratepayers as a whole. In those instances the utility is not receiving income for providing water.

In contrast, charges for the construction of, or improvement to, the general distribution system, however, are part of providing water services. *Kennewick* held that revenues paid by the ratepayers which was enough to pay back not only the cost of operating and maintaining a water system but also enough to pay the principal and interest on bonds for capital construction were part of the consideration for purchasing water. 67 Wn.2d at 593. The taxpayer's case, like that in *Kennewick*, involves undifferentiated payments from all rate payers for services, not charges to specific customers for new or enhanced services.

2. The statute, as construed by the caselaw, is not ambiguous.

The taxpayer argues that any ambiguity revealed by the caselaw must be construed against the Department and in favor of the taxpayer. *Shurgard v Department of Revenue*, 40 Wn.App. 721, 727, 700 P.2d 1176 (1985). The statute, however, is unambiguous. At the heart of the taxpayer's contention is the argument that RCW 82.16.010(12) authorizes the taxpayer to deduct from its gross income the cost of obtaining water and constructing a distribution system. The statute is clear that costs incurred in the performance of the utility's function may not be deducted:

> "Gross income" means the value proceeding or accruing from the performance of the particular public service or transportation business involved, including operations incidental thereto, but without any deduction on account of the cost of the commodity furnished or 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 added.] In *Kennewick*, the Court pointed out that the statute specifically forbade the deduction of capital expenditures. 67 Wn.2d. at 592.

> The act is clear and unambiguous. The tax is predicated upon the gross income received from the consumers for the utility service rendered. RCW 82.16.050 authorizes specific deductions to be made from gross income in computing the tax. No deduction is allowed for capital expenditures or interest.

Given this specific prohibition on deducting costs, if the legislature intended a utility to be able to deduct from its gross income all the costs of construction of its entire distribution system, then it is unlikely that it would have used such an indirect approach.[5]

[5]The taxpayer would not be heard to contend that its purchase of water from the City of . . . could be deductible. The cost of distributing the water includes the cost of building the distribution system. All are costs of operating a water distribution system.

Far from creating ambiguity, the Court of Appeals' quotation of *Kennewick* in *Seattle II*, as cited above, supports the interpretation that the public utility tax would apply to the facts of this case.

3. No evidence has been presented that the taxpayer's financing scheme was so materially different from that described in *Kennewick* as to justify a different result.

The taxpayer has not provided any detail of the differences it alleges exist between the Kennewick bond charges and its own, except to argue that its segregation of funds to pay the bonds creates a factual distinction from what was reported in *Kennewick.* We disagree. First, the taxpayer's funds are not paid to it in a segregated fashion. They come in a lump sum. When the revenue is received, city ordinances require that a fixed amount of the revenue sufficient to repay the monthly principal and interest payments on the bonds be paid into the bond fund or Reserve Account by the City Treasurer. *See e.g.*, Ordinance . . ., September 16, 1986. This same practice occurred in *Kennewick. See* Brief of Appellant, at 22-26.

Second, the ordinances provided by the taxpayer[6] and the description of the bonds analyzed in the briefs of the Appellant, Respondent and Amicus Curae in the *Kennewick* case do not demonstrate any material difference. Brief of Appellant, at 22-26.[7] Both involved bonds issued to repay bondholders for the construction of water distribution services. The bills for water service charged to the ratepayers did not separately set out the "capital construction" charges from the "operating" charges. In both instances, the bond resolutions authorized a lien on the gross revenue of the Taxpayer to repay the bonds and the Cities applied portions of the revenue received to reserve accounts as required by both accounting practices and the bond resolutions. In both cases the revenues received by the taxpayers were paid as consideration for and after the delivery of water. We do not find any basis for distinguishing *Kennewick* based on the methods of segregation and bond repayment.

[3] 4. **The Appeals Division has no authority to waive all interest.**

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[6] City of . . ., Ordinance No. . . ., January 27, 1997, Ordinance No. . . ., September 16, 1986; Ordinance No. . . . May 20, 1985; Ordinance . . ., July 5, 1967; Ordinance . . ., May 1, 1967, and Ordinance No. . . . May 2, 1960.

[7] The brief described the Kennewick financing scheme as follows:

> Ordinances of the City of Kennewick No. 567 and 587 (Exs. 7 and 8) set forth the procedures for handling the water revenues as they relate to the bond funds. On page 5 of Ordinance 567, the city obligates itself "to set aside from the gross revenue of said water supply and distribution system" the amount required to take care of the bonds. On the same page the respondent obligates itself to "establish, maintain and collect rates and charges for water that will provide sufficient *revenue* to pay the necessary cost of maintenance and operation of said system and to pay into said" bond funds the amounts to be set aside therefor.
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> To the same effect are sections 4 though 8 of Ordinance No. 567 and the provision of Ordinance No. 587 (Ex. 8). These ordinances clearly show that the bonds are to be serviced from the operating revenues of the water system.
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> When the water revenues are received by the city they all go into the water revenue accounts and thereafter, by the 20th of the month a transfer is made to the bond accounts of sufficient funds to meet the bond obligations of that month. In any month more revenue might be collected in the name of bond servicing than would actually be needed. The excess could be used for any purpose.

Because the case has lasted for fourteen months, the Appeals Division will waive any extension interest accruing beyond one year.[8] This waiver is authorized by RCW 82.32.105(3), which states:

> The department shall waive or cancel interest imposed under this chapter if:
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> (a) The failure to timely pay the tax was the direct result of written instructions given the taxpayer by the department; or
>
> (b) The extension of a due date for payment of an assessment of deficiency was not at the request of the taxpayer and was for the sole convenience of the department.

After a year we consider the extension as being for the sole convenience of the Department and not the taxpayer.

While we fully agree that the appeal should have been resolved sooner, nevertheless, we must deny the taxpayer's contention that that the Administrative Procedures Act requires the Department to waive interest that accrued as a result of "unreasonable delay." The Administrative Procedure Act does not apply to the Appeals Division of the Department of Revenue. Sections 410 through 598 of RCW 34.05 apply only to adjudicative proceedings. Adjudicative proceedings are hearings held by agencies where an opportunity for a hearing is *required* by statute or constitutional right. Such proceedings are defined in RCW 34.05.010(1):

> . . . a proceeding before an agency in which an opportunity for hearing before that agency is required by statute or constitutional right before or after the entry of an order by the agency. Adjudicative proceedings also include all cases of licensing and rate making in which an application for a license or rate change is denied except as limited by RCW 66.08.150, or a license is revoked, suspended, or modified, or in which the granting of an application is contested by a person having standing to contest under the law

Appeals before the Appeals Division of the Department of Revenue are not adjudicative proceedings because the hearing does not arise as a result of a statute or constitutional right. RCW 82.32.160 and RCW 82.32.170 require the Department to review assessments and applications for refunds. Neither requires a hearing. RCW 82.01.060(4) requires the Director of the Department to "[p]rovide by general regulations for an adequate system of departmental review of the actions of the department or of its officers and employees in the assessment or collection of taxes." The Director has elected to fulfill this requirement for review by adopting a hearing procedure. See WAC 458-20-100 (Rule 100). Nevertheless a hearing is not required by statute.[9] The taxpayer has the right to de novo hearings of assessments or denial of refunds in the

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[8] More than the additional interest, one clear detriment of the delay is the taxpayer's uncertainty as to its tax obligations and the need for an answer to the question posed by the taxpayer. In recognition of this need, the Division is currently in the process of reducing the time it takes to complete a case similar to this as well as issuing scheduling letters within two months of the date of filing.

[9] In license revocation, cigarette seizure, and log export enforcement actions, the Appeals Division does conduct adjudicative proceedings under the APA. Those proceedings are required by RCW 82.24.135(5), RCW 84.08.120, 84.41.120, and Rules 10001 and 10002.

Board of Tax Appeals, RCW 82.03.190, or in Superior Court, RCW 82.32.180. Therefore hearings by the Appeals Division are not constitutionally compelled. Since the majority of excise tax hearings in the Appeals Division are required neither by statute nor the constitution, the hearings are not adjudicative proceedings subject to the timeliness requirements of the APA.[10]

As to the taxpayer's argument that the delay is fundamentally unfair because interest on the assessment was accruing during the whole of the appeal, we note that the taxpayer always has the option of paying the tax as assessed, incurring no additional interest at all, and then petitioning for a refund or taxes and interest. RCW 82.32.060. Where the taxpayer chooses not to pay the tax as assessed, the funds remain available to the taxpayer during the appeal period and accrue interest for the taxpayer. Although there may be a difference between the market interest rates available to the taxpayer and statutory interest due the taxpayer on a refund, the ability of the taxpayer to apply market interest against the extension interest accruing during the appeal significantly ameliorates the burden the taxpayer criticizes.

We waive such extension interest as has accrued or shall accrue more than one year after the filing of this appeal.

DECISION AND DISPOSITION:

Taxpayer's petition is denied.

Dated this 28th day of April, 2000.

[10] We note that most adjudicative agencies acting under the APA do not complete hearings within ninety days. They merely commence such proceedings, i.e. issue a schedule for briefing and hearing within the ninety-day period. RCW 34.05.413. If the taxpayer's appeal had been filed under procedures currently in place in the Division, a briefing schedule would have been issued within ninety days.