Cite as Det. No. 86-237, 1 WTD 115 (1986)

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 SECTION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Refund of	)	D E T E R M I N A T I O N
	)	No. 86-237
. . .	)	Registration No. . . .

[1] RCW 82.04.4281: SERVICE BUSINESS & OCCUPATION TAX -- INTEREST DEDUCTION --"FINANCIAL BUSINESSES" -- INVESTMENTS -- LOANS TO SUBSIDIARIES -- SURPLUS FUNDS -- ANALYTICAL STEPS FOR DETERMINING DEDUCTION. A large manufacturing company which made loans of surplus funds held not to be "ejusdem generis" with banking, loan, security businesses and was therefore not a "financial business" within the intent of RCW 82.04.4281. It was therefore entitled to a refund of Service business tax paid upon interest received from its various subsidiaries.

This headnote is provided as a convenience for the reader and is 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 AND PLACE OF HEARING: February 21, 1986; Seattle, Washington

NATURE OF ACTION:

The taxpayer has petitioned for a refund of Service classification business and occupation taxes paid upon interest income it has received from loans of surplus funds to its various subsidiaries.

FACTS AND ISSUES:

M. Clark Chandler, ALJ -- The taxpayer . . . is engaged in the manufacture and sale of heavy equipment and other steel products. The taxpayer, as a manufacturer, received interest on loans to subsidiary corporations and now requests refund of the Service business tax reported and remitted upon such gains in the following amounts:

1981	$111,839.95
1982	106,159.59
1983	37,755.22
1984	70,906.20
1985	94,000.00 (est.)

The taxpayer contends that the interest income constitutes, and is therefore exempt business tax, as "amounts derived from . . . the use of money as such." (RCW 82.04.4281.) It is maintained that it is not a banking, loan, security, or other financial business, as those terms are used in RCW 82.04.4281, nor as construed by the Washington Supreme Court in Sellen Construction Co. v. Department of Revenue, 87 Wn.2d 878 (1976). The taxpayer is therefore of the opinion that, under RCW 82.04.4281, it is not subject to the Washington business and occupation tax. That is, the taxpayer concedes that the interest from subsidiary loans constitutes gross receipts (income) of the business, but is nevertheless deductible under statute.

The taxpayer has called the Department's attention to the fact that the Department has consistently, since the 1976 Sellen case, supra, considered or given weight to the degree or amount gross interest income from loans contributes to a taxpayer's (parent in this case) gross income of the business. It is in this regard that the taxpayer explains an error occurring in 1983 when an identical refund issue petition for the years 1977 through 1981 was denied by an Administrative Law Judge. The Administrative Law Judge found that interest income of the type here at issue constituted five percent of the taxpayer's gross income of the business. This result has been found to be due to the fact that the income considered by the Administrative Law Judge to be gross income was, through some inadvertence or misunderstanding, actually net income. Consequently, the percentage that should have been considered at the time was .4 percent rather than 5.0 percent.[1] The taxpayer states that inter-company interest percent relative to gross revenue for all the years involved, 1977-1985, is .394. (See taxpayer's Schedule II, attached.) This includes years in which, due to the nation's economy, interest rates reached unprecedented levels. The refund currently sought by the taxpayer for the years 1981 through 1985 reflects, in ascending order from 1981, the following interest: gross income percentages: .677, .903, .222, .219, and .244.

The taxpayer thus emphasizes that its average interest percentage of gross income is low compared to similar type percentages considered in various court cases, appeals, and other Departmental

[1]The Judge's denial of the taxpayer's petition was not based on the percentage factor alone; however, it was noted: " . . . The lending activity was regular and recurrent and the income was significant, whether isolated ($34,384,119) or compared to gross income (five percent)."

Determinations in which the taxpayer's attorney firm participated and therefore has first-hand knowledge. In these cases the statutory deduction was found to be applicable. For example:

Company	Percentage
Taxpayer (D)	.394%
Sellen (SC)	.5
Olympia Brewing Co. (SC)	.2
Blue Cross (SC)	3.0
Howard S. Wright (SP)	1.9
Shuchart Industrial Contractors (SP)	2.4
King County Medical Blue Shield (SC)	"Small"

Code: SC-Supreme Court; SP-Superior Court; D-Department of Revenue

Further, the taxpayer expresses the sincere opinion that it is the legislature's intent not to impede the methods or ways funds flow between parent and subsidiaries. This, according to the taxpayer, is evidenced by RCW 82.04.4281 which allows a parent corporation to contribute financially to a subsidiary and bring back a return in the form of a dividend. It is thus contended that interest received from loans of surplus funds are not taxable. It is claimed that the parent is only providing necessary funds to its subsidiaries. Such loans have the additional beneficial effect to provide the various family entities a visual or first-hand appreciation of the cost of money. Also, a parent, through such loans, can evaluate the subsidiaries' proficiency relative to its and other businesses.

In the interest of fully and accurately presenting the taxpayer's position in this respect, we quote from the taxpayer's post hearing paper entitled, "Grounds for Distinguishing Determination No. . . . (Prior Determination):"

> 3. The legislature has manifested a clear intent not to tax the flow of capital between parent and subsidiary corporations. In the case of the flow of funds from subsidiaries to parent, this legislative intent applies whether or not the flow is by way of dividends or interest:
>
> RCW 82.04.4281 Deductions--Investments--Dividends from subsidiary corporations. In computing tax there may be deducted 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. (Underlining taxpayer's.)
>
> Because a parent can control whether funds flowing from its subsidiaries are paid by way of dividends or by way of interest, it makes no sense to have a tax distinction between the two forms of payment. Such a distinction would be no more than a trap for the unwary.

> It is of interest to note that the legislative intent is consistent with the pattern for federal tax purposes. Funds flowing from a parent to a subsidiary are free of tax under IRC §351 and IRC §118. Funds flowing from subsidiaries to parent, whether by way of dividend or interest, are also eligible for tax-free treatment. If the corporations are consolidated, there will be no tax under the consolidation regulations. In the absence of consolidation, the parent may exclude 100% of a dividend paid by a wholly-owned subsidiary (unless there are multiple surtax exemptions claimed in which case the dividend exclusion is still 85%). IRC §245. If the funds from the subsidiaries to the parent flow by way of interest payments, the subsidiaries will pay no income tax on the funds because of the interest deduction allowed by IRC §163.

The taxpayer also tenders its observation that "typically, parents are likely to use equity for long term capital and a debt for short term or working capital when funding their subsidiaries. Neither the federal nor state tax systems bias the investment choice between debt and equity by tax considerations." In the instant matter the interest is actually paid by subsidiaries either by cash or book entry; however, the loans are often merely renewed. The taxpayer also argues that it is not in competition with banks, etc., by stressing the facts that it does not deal with the public nor is it regulated in the same manner as lending institutions.

In support of its position the taxpayer has cited the following court decisions and a Board of Tax Appeals order:

> John H. Sellen Construction Co. v. Revenue, 87 Wn.2d 878 (1976)
> Rainier Bancorporation v. Revenue, 96 Wn.2d 669 (1982)
> Howard S. Wright Construction Co., et. al. v. Revenue, Thurston County Superior Court, No. 79-2-01310-0 (1981)
> Cowles Publishing Co. v. Revenue, BTA Dockets No. 12241, 12242 (1977)

The taxpayer has also cited two Department of Revenue Determinations it deems to be squarely on point in which the appellants were granted tax relief relative to loans by a parent to its subsidiaries. Under RCW 82.32.330 (Secrecy enjoined) the Department is constrained from publishing the names of these taxpayers.

DISCUSSION:

[1] The controlling statute is RCW 82.04.4281 which grants the following business and occupation tax deduction from gross income of the business:

> **RCW 82.04.4281 Deductions---Investments---Dividends from subsidiary corporations**. 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.

Thus, in order for the interest earned by the taxpayer to be subject to the business tax it must be a "financial business."

In our consideration of this statutory deduction relative to its applicability to the taxpayer's factual situation, we have reviewed some 28 Departmental Determinations issued since 1976 which fall on both sides of the fence, so to speak, relative to taxability or nontaxability of interest received from loans to subsidiaries. In the main, the conclusion reached resulting from this review is that decisions have been made based upon qualitative distinctions rather than technical legal considerations. Accordingly, we make the following observations:

1.The courts have noted the degree of interest income to gross income but have explicitly denounced the adoption of a percentage test for deciding these matters. Consequently, such a factor is only one of several that should be considered if at all. We are unable to read into the statute that the amount of interest earned factor itself is a criterion for finding a parent corporation as being similar to a "financial institution."

2.The Department has tended to consider deduction more favorably under the statute for interest earned from surplus as opposed to borrowed funds (probably because of the Sellen case, supra, which involved investment of surplus funds exclusively). This is a distinction without much substance. See, concurring opinion, Bancorporation, supra, at page 675. In fact, it would appear that borrowing funds to loan to subsidiaries would be less an "investments or use of money as such" than would be the case when a parent's surplus funds are used. On the other hand, loans made from surplus funds would appear to be of a more competitive nature relative to other lenders.

3.While it is obvious that the legislature, through its enactment, fully intended to prevent taxation of dividends paid by subsidiaries to their parents, we are of the opinion that the legislature has not contemplated the situation involving parent loans to subsidiaries. The initial intent of the legislature, it seems clear, was to obliterate the concerns expressed in the previously cited court cases about the possibility of taxing any person with a sizable investment portfolio under the guise of "engaging in business," irrespective of the fact that this state does not have an income tax or a tax on intangibles. In any event, we conclude that I.R.S. provisions relating to the flow of funds between corporations are not material to the issue presented.

4.In the beginning, the Department of revenue taxed interest earned from loans to subsidiaries based upon the proposition that corporations are persons "engaging in business" taxable under the Revenue code

> measured by "gross income of the business" (RCW 82.04.080) which excludes any deduction for interest. The Department also took into account that RCW 82.04.440 provides for taxation on multiple activities. In applying RCW 82.04.4281, the courts have rebuffed this taxation approach. In reaction to the previously cited Sellen case, the Department next advanced the proposition that "income from activities which are essentially in competition with financial businesses where such activities are a regular part of the taxpayer's normal business practice" (ETB 505.04.109) is taxable. Our review of the Department's handling of these situations reveal that for the most part taxpayer loan activities are more "indirectly" than "essentially" in competition with financial institutions. The word "essentially" must be interpreted within the holding of Bancorporation v. Revenue, supra, as to what constitutes a financial business.

In most factual situations in which the same issue here presented must be resolved, the following analytical approach can be utilized:

ANALYSIS STEPS
to RCW 82.04.4281

Questions	Answers	Tax Result
Gross income?	yes	yes
Deminimis interest return compared to gross income?	yes	no
Essentially in competition with banks, etc.?	no/yes	no/yes
Regular and recurring activity?	no/yes	no/yes
Use of money as such?	Yes	no
Ejusdem generis with banks, etc.?	no	no

A compilation of the "yes" and "no" answers in the Tax Result column should normally indicate whether interest received from loans to subsidiaries is entitled to deduction; however, the ejusdem generis question should be heavily weighted in all cases. In applying the forgoing analytical steps to the instant factual situation, we conclude that there are four "no" answers and two "yes" answers in the Tax Result column.

The first question may at first glance seem unnecessary; however, to be taxable in the first place the amounts sought to be reached for excise taxation must constitute gross income of the business accruing by reason of the transaction of the business engaged in. If the interest being considered in this case is "gross income of the business" it is taxable unless it is deductible under RCW 82.04.4281. Thus, we place a "yes" answer in the tax result column. The remaining analysis questions are pertinent to the exemption itself.

The second question gets at the significance of the taxpayer's loans relative to the gross income of its stated business--manufacturing. While the actual interest earned is a substantial amount, the percentage of interest income to gross income is extremely small. Lower, in fact, than the courts have noted in decisions relative to the issue here presented. In the Rainier Bancorporation case, supra, Rainier's loans to its subsidiaries resulted in interest, which the court held taxable, accounting for 41.1 percent of gross income during its first audit and 58.1 percent during the second audit period. In Sellen, supra, the percentages considered were generally less than three percent and the court found that the term "financial business" must be given its ordinary and common meaning. It concluded that the common meaning of the phrase "contemplates a business whose primary* purpose and objective is to earn income through the utilization of significant cash outlays." Of the $60 million lent by Rainier to its subsidiaries during the relevant audit periods, less than one-half of the funds came from Rainier's surplus funds. Most of the money was borrowed. *(The word "primary" is emphasized by the ALJ.) With this information in mind and in comparing it to the instant factual situation we conclude that a "no" answer must be placed in the Tax Result column.

The third analytical step involves the consideration of whether the taxpayer is essentially in competition with banks, etc. In the 1976 Sellen decision the court dealt exclusively with investments. The various respondents, who were declared by the court not to be "financial businesses" for purpose of the statutory deduction, had received interest income from investment of excess, endowment, and reserve funds. The investments were made for the purpose of benefiting the various businesses. It is clear that in the Sellen factual situation income was received by the respondents from "investments or the use of money as such." Consequently, other than proclaiming how the words "other financial businesses" must be interpreted, the Sellen decision does not directly reach the issue of loans of surplus funds with which we are faced. This brings about the "competition" question.

After Sellen was decided, the Department of Revenue issued ETB 505.04.109 which, speaking of the case, states in pertinent part:

> Under the holding of the court the income items listed met the two conditions for the deduction of RCW 82.04.430(1): [Now 82.04.4281]
>
> 1. they were amounts derived from investments and
>
> 2. the business activity did not constitute financial business.
>
> In the course of its decision the court gave its endorsement to ETB 368 and quoted with approval the following language therefrom:

> Where the activities involved are essentially in competition with financial businesses and this is a regular part of the taxpayer's normal business practice, the department believes that the activities constitute financial business and are subject to tax.
>
> The court did not define "investments" in its opinion. However, it noted that enterprises "specializing in the handling and investment of funds" would not be entitled to the statutory deduction but that those "making incidental investment of surplus funds" should receive the deduction.
>
> Under the holding of the court in Sellen, income from the incidental investment of surplus or excess funds by persons who are not themselves in a security, investment, or financial business is not subject to tax.
>
> However, no deduction is permitted with respect to
>
> 1. interest or similar charges from extension of credit o customers;
>
> 2. interest or similar financial charges relating to real estate transactions (see RCW 82.04.390); nor
>
> 3. income from activities which are essentially in competition with financial businesses where such activities are a regular part of the taxpayer's normal business practice.

We have difficulty in finding that the taxpayer is essentially in competition with formal lending institutions. It appears that the Department's hereto now rationale that if a parent's subsidiaries could not obtain funds from the parent it would be forced to look to banks for loans -- thus, the parent is in competition with "financial business" -- is suspect. To follow this reasoning is to fall into the situation abhorred by the Supreme Court and illustrated by the following syllogism: Financial institutions lend money. Uncle Bob makes personal loans to nephew Tom and niece Ann. Therefore, Uncle Bob is a financial institution. A parent corporation in all feasibility can place its surplus funds into a subsidiary using an interest bearing promissory note procedure for any number of reasons including an investment of funds, and not necessarily because the subsidiary cannot get along without the funds or that it cannot borrow from a bank. It is in this area that the taxpayer's argument to the effect that the legislature intends a nontaxable flow of funds between members of a corporate family takes on creditability. We have also noted that in Rainier Bancorporation the litigants agreed that the income at issue (including loan interest) was derived "from investments or use of money as such," a prime requirement for deduction under RCW 82.04.4281. We conclude that the taxpayer, a manufacturer and rated in the approximate middle of Fortune's top 500 corporations, is not essentially in competition with banks, etc. Consequently, we place a "no" in the Analysis' Tax Result column.

As the fourth matter, the taxpayer's activity is, apparently, regular and recurring. Thus we must put a "yes" in the Tax Result column. Fifth, it is clear that the receipt of interest from subsidiary loans result from "investments or use of money as such" (See Rainier Bancorporation, supra). Therefore, a "no" must be placed in the Analytical Tax Result Column.

Finally, is the taxpayer "ejusdem generis" with banking, loan, or security businesses so as to qualify as an "other financial business" under the statute? First off, the taxpayer must be found similar to those designated in the statute by precise or specific terms, i.e., banking, loan, or security businesses. It is not similar. It is not regulated as are the specifically named type of businesses nor does it, in this respect, hold itself out to the public for purpose of making loans. It is not in the market place in a public, competitive business. It is not the primary purpose and objective of the taxpayer to earn interest income, a fact necessary to qualify as a "financial business." See Sellen, supra, at 882. The Department has explicitly recognized in its Excise Tax Bulletins 505 and 368 that "it does not follow that every act of business or every investment and grant of the use of money is held to be financial business. . . ." The ordinary and common meaning of the words "loan business" contemplates a business whose primary purpose and objective is to earn income by making loans. Although the taxpayer did make loans at interest, the context in which these loans were made had none of the generally recognized indicia of the "loan business." We conclude that the taxpayer is not ejusdem generis with banks, etc., and enter a "no" in the Tax Result column.

The Sellen case has told us in a 7-2 decision that "other financial businesses" are those that are comparable to banking, loan, or security businesses but technically not falling within one of the three categories. In the Rainier Bancorporation decision the court found Bancorporation, for numerous valid reasons, to be similar and comparable to the aforementioned types of businesses. Under the guidelines furnished by these two cases, Howard S. Wright Construction Co., supra, and two Board of Tax Appeals decisions, Cowles Publishing, supra, and Timberland Forest Products, Inc., Docket No. 18827 (1980), we find that the taxpayer is not a "financial business" under RCW 82.04.4281. Thus, its interest income is received as the result of the investments or use of money as such and therefore exempt from the Service business tax under RCW 82.04.4281.

DECISION AND DISPOSITION:

The taxpayer's petition for refund is sustained. The Audit Section will determine the correct amounts and issue a credit or refund as proper within the time limitations of RCW 82.32.060.

DATED this 29th day of August 1986.