Cite as 1 WTD 343 (1986)

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

In the Matter of the Petition For Correction of Assessment of	)	F I N A L D E T E R M I N A T I O N
	)	No. 85-112A
. . .	)	Registration No. . . .
	)	Tax Assessment No. . . .

[1] Rule 106(2): CONTRIBUTION OF CAPITAL -- EXEMPTION -- ARTICLES OF INCORPORATION -- STOCK.
Rule 106(2) does apply where the articles of incorporation specifically prohibit the issuance of stock.

[2] Rule 106(2): MISCELLANEOUS: CONTRIBUTION OF CAPITAL - EXEMPTION- INTEREST EQUIVALENT TO STOCK - 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.

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 sonstruing or interpreting this Determination.

NATURE OF ACTION

The Audit Section for the Department of Revenue audited the records of the taxpayer for the period beginning on January 1, 1980 through June 30, 1984 and thereafter issued an assessment for delinquent taxes. An appeal was timely filed and the Administrative Law Judge upheld the assessment. On or before the new due date for payment, the taxpayer remitted the full amount of the assessment. The petition for review now pending before the Director is for a review of the Administrative Law Judge's decision and is now treated herein as a petition for refund since the tax has been paid.

FACTS AND ISSUES

Fujita, Chief--This taxpayer was incorporated in 1921 as a non-profit corporation. It currently provides utility services for around 1,650 customers in a relatively small geographical area. The taxpayer characterizes the company as a "stock" company which is wholly owned by its "shareholders." To become a "shareholder,"

the person must own real property in the service area; the Board of Trustees must approve the application; and a "capital contribution" must be paid to the taxpayer before ownership privileges are granted. The "share" prices are somewhat less than book value due to the minority discount factor and overall lack of marketability. See Taxpayer's initial protest dated January 28, 1985.

Taxpayer contends in the alternative, that if these relationships with the taxpayer cannot be considered "shareholder" in quality, then they are "equity interests" in nature; the functional equivalents of stock. See Taxpayer's protest to the Director date December 17, 1985.

The auditor disregarded the accounting characterization of the money as contributed to capital and the amounts were reclassified as gross receipts for purposes of the business and occupations tax. Upon review of that decision, the Administrative Law Judge rejected a theory that Rule 114 (WAC 458-20-114) dealing with dues as a deduction from gross receipts) applied, because the money paid did not "genuinely represent the value of membership in a club or similar organization." Further, the Administrative Law Judge did not accept the taxpayer's characterization of stock ownership, because the taxpayer's articles of incorporation specifically prohibited the issuance of shares. Therefore, the analysis concluded that Rule 106 was not available to the taxpayer, because a finding of stock ownership is required before the rule could apply. From the petition (taxpayer's protest dated December 17, 1985), it is apparent that the taxpayer seeks reversal of that conclusion of law pertaining to Rule 106, since the taxpayer offers no arguments with respect to Rulw 114. Thus, we limit this dicussion to only the application of Rule 106. The essence of the taxpayer's argument is that the membership relationship with taxpayer is essentially stock and therefore within the spirit of Rule 106.

DISCUSSION

First, we duly note that the taxpayer has requested a formal hearing. Under RCW 82.32.160 and Rule 100, hearings are granted at the discretion of the Department and we choose in this instance not to exercise that discretion, because the facts are not in dispute and the gravamen of the taxpayer's issue is whether, as a matter of law, a corporation which is prohibited from issuing shares of stock can fall within the scope of Rule 106 (WAC 458-20-106) by issuing memberships (which are argued to be tantamount to equity interests). After lengthy thought and consideration, we are compelled to answer that question in the negative.

We begin with a review of the taxpayer's Articles of Incorporation and the By-Laws[1]. Under Objects and Purposes of the Articles of incorporation, the source of the corporation's powers, paragraph (k) is quoted as follows:

> . . . This corporation shall have no capital stock, and shares of stock therein shall not be issue. The interet of each incorporator or member shall be equal to that of any other, and no incorporator or member can aquire any interest which will entitle him to any greater voice, vote, authority or interest in the corporation than any other member.

Article II, Section 1 of the By-Laws is quoted as follows:

> The membership fee shall be $25.00 for each membership, and when connecting to the company's power lines, the member shall pay a resonable service connection fee in an amount to be determined by the Board of Trustees who shall also have the power to fix the amount that shall be paid on a membership before service is connected and how the balance shall be paid by a uniform rule applocable to all. The Board shall have the power to reduce the membership fee by refunding to members from time to time as finances permit.

Specifically, the taxpayer argues that Rule 106 (2) applies, because the memberships described in the By-Laws are stock or essentially an "equity interest" (just like stock) and therefore exempt from tax as contribution of capital. That rule is quoted as pertinent and as follows:

> A transfer of capital assets to or by a business is deemed not taxable . . . . The following examples are instances when the tax will not apply.
>
> (2) Transfers of capital assets by an individual . . . to a corporation . . . in exchange for capital stock therin. . .

Essentially, taxpayer argues that the interests are stock and if not, then the Department should elevate the substance of what the taxpayer has done over the form. Or stated another way, the taxpayer would like the Department to ignore what the taxpayer has said (in the Articles of Incorporation) and to tax it according to what it believes it has done. We decline to do so, although there is no Washington state case authority directly on point. However,

---

[1] The Articles of Incorporation and the By-Laws are part of the Department's files and therefore, they shall be treated for purposes of this review as part of the record.

we find persuasive rationale in the federal courts which we adopt to support our conclusion in this case.

[1] First, we find that the interest is not stock. The articles of incorporation prohibit the issuance of stock. The language could not be any more plain.

[2] We now turn our attention to the taxpayer's alternative argument that the membership interests are stock equivalents. We begin this discussion with Higgins vs. Smith, 308 U.S. 473 (1939), where the U.S. Supreme Court had occasion to discuss the power of the Internal Revenue Service (IRS) to disregard the form of the taxpayer's transactions to impose a tax. In discussing the case of Burnet v. Commonweath Improv. Co., 287 U.S. 415 (1932), the Higgins court is quoted as follows from page 477:

> . . . In the Commonwealth Improve. Co. Case, the taxpayer, for reasons satisfactory to itself voluntarily had chosen to employ the corporation in its operations. A taxpayer is free to adopts such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the disadvantages.
>
> On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or sham may sustain or disregard the effect of the fiction as best serves the purposees of the tax staute. To hold otherwise would permit th eschemes of taxpayers to supersede legislation in the determination of the time and manner of taxation. . . .

Clearly, this court recognized that the government does have the authority to look through the form of the transaction to reach a result that would not undermine the statutory intent. Does this authority, however, require the government to elevate substance over form at the insistence of the taxpayer? We think not.

In Spector v. Com., [81-1 USTC paragraph 9308 at page 86, 797], 641 F.2d 376 (5th Cir. 1981), the court is quoted as follows:

> Moreover, we perceive no unfairness in allowing the Commissioner to challenge the form of a transaction as devoid of "economic reality," while placing limitations[2]

---

[2] Spector recognizes limited use of the doctrine of substance over form; it recognizes an exception for mistake, overreaching,

on the taxpayers' ability to do the same. As the court emphasized in Harvey Radio Laboratories, Inc. v. Commissioner, [73-1 USTC paragraph 9121], 470 F.2d 118, 120 (1st Cir. 1972):

> While we do not agree that a taxpayer, to suit his convenience, can freely avoid the consequences of his agreement by showing that the "economic realities" were otherwise, we have no quarrel with those cases which accord such an option to the Commissioner. . . . The parties are free to make their own agreement. The Commissioner, on the other hand, has to deal with the apparent agreement he is faced with. It does not seem unfair that he should be less strictly bound to its bona fides than are the parties themselves.

In Winn-Dixie Montgomery, Inc. v. Untied States, [71-USTC paragraph 9488], 444 F. 2d 677 95th Cir. 1971, the court had before it a case where the taxpayer's agreement specifically said that there would be an allocation of the purchase price to goodwill. However, according to the taxpayer, there was never the intention to actually allocate any amount of money to goodwill and the IRS, it was argued, should be bound by that intention. At page 682, the court is quoted as follows:

> No decision holds or suggests that such a one-sided, uncommunicated apportionment of a sales price is conclusive on the taxing authorities, and it is obvious that it would be dangerous and unfair to lay down that categorical rule. The whole trend of the law in this area is against binding the Revenue Service by such a secret, unilateral, subjective allocation which is not carried over into the agreement.

While these cases are not on all four legs with the issue now before us, the policies are sound and necessary for effective tax administration. In this case the taxpayer's articles of incorporation specifically reject the concept of stock ownership. The taxpayer is now arguing that what the corporation has said is not relevant but what it actually did is. To follow such a rule would at the very least ignore the articles of incorporation, but more importantly, it would erode the predictability of the effect of the party's legal declarations. If we were 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 on what the taxpayer "really meant" rather what was

---

duress or other reason which, in an action between the parties to the transaction, would set the agreement aside. Such is not the case in this matter now pending before us.

said. The potential confusion inherent in subjective speculation is immense and we decline to venture into such murky waters.

Thus, we believe it to be sound policy to limit the taxpayer's use of elevating substance over form. The taxpayer was free to choose the form of which it desired, and there is no reason, other than to escape the clutches of the tax collector, to disregard that form. The availability of that kind of analysis is generally limited to use by the Department when it believes that the transactions may be sham and lack economic reality. To allow the taxpayer to elevate substance over form would make predictable tax administration nearly impossible if it became the policy to allow the taxpayer to determine its tax liability on what it believes it has done as opposed to what it says it does.

DECISION AND DISPOSITION

The petition for refund is hereby denied.

Dated November 10, 1986.