Cite as Det. No. 90-84, 9 WTD 157 (1990)

BEFORE THE INTERPRETATION AND APPEALS DIVISION
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. 90-84[1]
. . .	)	Registration No. . . .

[1] **RULE 197, RCW 82.04.080, AND RCW 82.04.090:** B&O TAX --GROSS INCOME -- VALUE PROCEEDING OR ACCRUING -- PENSION TRUST FUND -- INVESTMENT ADVISOR -- FEE. Where a taxpayer manages a pension plan trust, hires an expert to advise how the funds therein ought to be invested, and the expert withdraws its own fee directly from the trust funds, the amount of such fee is "value proceeding or accruing" to the taxpayer if the taxpayer itself is legally entitled to receive the fee.

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 HEARING: August 25, 1988

NATURE OF ACTION:

Petition for partial refund of B&O tax on fees earned for management of a pension plan trust account.

FACTS AND ISSUES:

Dressel, A.L.J. -- . . . Trust Company (taxpayer) is a subsidiary of . . . Company and is a "non depository trust co. providing trust & investment management services to tax-free corporate pension plans." In this action it requests a refund of business and occupation (B&O) taxes allegedly overpaid in the amount of $ . . . .

[1] The reconsideration determination, Det. No. 90-084A, is published at 9 WTD 287 (1990).

To lay out the pertinent facts, we quote from the taxpayer's petition:

> . . . has a number of affiliated corporate entities each of which performs a slightly different function in the overall financial services plan of the entity. One of these is . . . Trust Company. The primary business of . . . Trust Company (". . .TC") is to serve as a trustee and manage the assets of pension, profit sharing and other employee benefit plan trusts, each of which is exempt from federal income taxation under the Internal Revenue Code. These "Participating Plans" are typically the plans of medium to large companies located across the country.
>
> As a vehicle for investing the assets of the Participating Plans, . . .TC created and serves as the trustee of the . . . Trust Company Commingled Employee Benefit Funds Trust (the "Trust"). The Trust is a collective investment fund which consists solely of assets of the Participating Plans. The Trust itself is subdivided into twelve investment funds with differing investment objectives (the "Funds"). The Funds invest money in different markets, thus spreading the risk and offering greater opportunity for gain in a variety of areas.
>
> . . .TC receives a fee from each of the Participating Plans for its trust and investment management services. The fee is calculated as a percentage of each Participating Plan's assets invested in each Fund. The fee is paid quarterly either by the corporate sponsor of the particular Participating Plan directly from the sponsor's own income stream, or in some situations may be paid from the assets of the Participating Plan itself.
>
> The breakdown of this basic fee payment arrangement varies depending upon the nature of the Fund and the arrangement with the Participating Plan. There are basically two different mechanisms for payment. It is important to explain each of these two mechanisms so that you clearly see why in one situation . . .TC is entitled to a B&O tax refund.
>
> In Alternative #1, . . .TC receives a substantial fee from a particular corporate sponsor of a Participating Plan and in turn pays as the expense of . . .TC the fees charged by investment advisors to the particular Fund and a fee to the custodian bank which holds the assets of the Fund. An example of this mechanism is shown below:
>
> Equity 1 Fund
>
> 1% Fee rate for Participating Plan
>
> $1,000,000 Participating Plan's investment

$10,000 Fee billed to Plan and paid to . . .TC by Plan (or corporate sponsor)

($7,000) Paid by . . .TC to Advisors ($6,000) and its Custodian ($1,000)

$3,000 Retained by . . .TC

In Alternative #2, the compensation arrangement is different. This applies to a fund called the Real Estate Equity Fund ("REEF"). REEF invests its funds in other collective funds maintained by other managers. Total charges to REEF are calculated as a percentage of the total assets of REEF and are deducted prior to calculation of REEF's unit value. All but one of the investment managers to REEF deduct their fees directly from the collective investment funds which they maintain and . . .TC receives as gross income only the net difference. The example of this arrangement is indicated below:

REEF Fund

1% Fee rate for all advisors to Participating Plan

$1,000,000 Participating Plan's investment

$10,000 Total "costs" to Plan

($6,000) Deducted by Manager from its collective fund

$4,000 Fee paid to . . .TC by Plan from investment in Real Estate Equity Fund

($1,000) Paid by . . .TC to its Custodian and other Manager

$3,000 Retained by . . .TC

Solely to reflect on its books the REEF compensation arrangements in a manner consistent with the compensation arrangements for the other eleven funds, . . .TC has recorded as income the full $10,000 of total "costs" to the Plan. In addition to reporting as income the $4,000 fee paid to . . .TC by the Plan, . . .TC also records the following journal entry to increase gross income and investment advisory fee expense:

Debit - Investment manager and trustee fee expense $6,000

> Credit - Gross Income $6,000
> As shown in Alternative #2, the entry has no affect on cash or gross profit because REEF is actually paying the $6,000 amount directly to its Manager and not to . . .TC at all.
>
> Because . . .TC overlooked the bookkeeping entry described above, . . .TC in the past has paid business and occupation tax on the amount of gross income recorded by the noncash entry for the refund. That payment of business and occupation tax is in error.
>
> . . .TC is entitled to a refund of the following amounts for business and occupation taxes incorrectly paid with respect to the REEF income not actually received by . . .TC for the years indicated:
>
> . . .
>
> . . .TC hereby requests a refund in the amount indicated together with interest as provided by statute.

The issue in this case is whether fees withdrawn directly from a trust fund by an investment advisor (investment manager) are taxable gross income to the trust manager (taxpayer).

DISCUSSION:

[1] The business and occupation (B&O) tax is asserted, in this case, against gross income of the business. See RCW 82.04.220. "Gross income of the business" is defined at RCW 82.04.080 as:

> . . . the *value proceeding or accruing* by reason of the transaction of the business engaged in and includes gross proceeds of sales, compensation for the rendition of services, gains realized from trading in stocks, bonds, or other evidences of indebtedness, interest, discount, rents, royalties, fees, commissions, dividends, and other emoluments however designated, all without any deduction on account of the cost of tangible property 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 ours.)

The "value proceeding or accruing" is "the consideration, whether money, credits, rights, or other property expressed in terms of money, actually received or accrued." RCW 82.04.090.

To prudently manage and invest the monies in its real estate equity fund, the taxpayer hires an investment manager. The investment manager is due a certain fee for its services. Rather than billing the taxpayer for its fee, the investment manager simply takes it directly out of the trust funds the manager is hired to invest. It is authorized to do this by contract with the taxpayer who is, in turn, authorized by its corporate client. The fee withdrawn by the investment manager is never

"actually received" by the taxpayer. Determination 88-202, 5 WTD 379, 381 (1988). It is placed in the trust fund by the client and then withdrawn by the investment manager. The fee, thus, bypasses the taxpayer.

If the fee is to qualify as "value proceeding or accruing," it must do so as "actually accrued" because it is not "actually received." RCW 82.04.090. In Determination 88-202, *supra*, we decided a similar question of whether a fee (commission) was actually accrued by examining whether the taxpayer was entitled to receive it. Such an approach is consistent with WAC 458-20-197 (Rule 197), "When tax liability arises." This rule reads in part:

> ACCRUAL BASIS. When returns are made upon the accrual basis, value proceeds or accrues to a taxpayer as of the time the taxpayer actually receives, *becomes legally entitled to receive* or in accord with the system of accounting regularly employed enters as a charge against the purchaser, customer, or client the amount of the consideration agreed upon, whether payable immediately or at a definitely determined future time. (Emphasis ours.)

Notwithstanding the fact that this accrual basis taxpayer did not actually receive the disputed fee, we think the taxpayer was *entitled to receive it*. The examples given by the taxpayer in its petition suggest that it was so entitled. Regarding the "Equity 1 Fund," it is indicated that 1% is the "Fee rate for Participating Plan." For the "REEF Fund," 1% is the "Fee rate for all advisors to Participating Plan." Those two examples[2] and the fact that the taxpayer has not demonstrated any difference in its contracts with clients in cases where funds are invested in the REEF as opposed to elsewhere convince us that the taxpayer's fee for managing each fund is the same set percentage of the client's monies in whichever fund. We are not persuaded that the additional language in the REEF example, "all advisors to," means that the agreement between client and taxpayer calls for the compensation owed the taxpayer by the client to be any less in the case of the REEF than it is with the Equity 1 or other fund. We acknowledge that the mechanics of payment are different in that the REEF advisor helps itself to its fee while in the Equity 1 fund the advisor is paid by the taxpayer. In both cases, however, we are convinced that the agreement between client and taxpayer reflects the same gross percentage, 1% or whatever. It is, thus, our conclusion that the taxpayer is "legally entitled to" the gross total fee paid by the client to all advisors/managers. It follows that such gross amount has accrued to the taxpayer, that such amount is "gross income of the business," and that such amount is the proper measure of the taxpayer's B&O tax obligation.

We do not perceive that the client, in the case of the REEF, hires two parties, the taxpayer to manage the pension fund, and the investment advisor to recommend how the monies should be invested. We believe it much more likely that the client hires only the taxpayer to take care of its pension fund for a certain set percentage of the fund and that the taxpayer then hires different

[2] As well as language in the taxpayer's petition preceding the two examples. Also, in a letter of January 18, 1990, the taxpayer's representative states that the standard taxpayer-client fee agreement makes no reference to the payment structure the taxpayer has negotiated with the various investment managers. Thus, we assume the taxpayer is entitled to the same gross fee from its client whether the pension funds are to be placed in a REEF or some other type of account.

investment advisors to take advantage of their particular expertise in whichever particular market the funds happen to be invested.

Assuming that this perception of the contractual arrangements is correct, we pose this illustration of the consequences of adopting the tax treatment urged by the taxpayer. The business and occupation tax is pyramidical in structure. Each transaction is taxed. The same goods or services may be sold more than once. Each such sale is a transaction. The inevitable result is that many goods and services are taxed twice or more. For instance, in the construction arena, an owner of land might hire a prime contractor to build an office building for $10,000,000. The prime contractor, in turn, would probably hire mechanical, electrical, plumbing and other subcontractors to help it complete the project. Say each sub is to be paid $1,000,000. The prime is still taxed on the total $10,000,000 even though several $1,000,000 increments of that total will be turned over to subs. Each sub also pays B&O tax on the $1,000,000 fee it receives. In this fashion the B&O tax pyramids or is duplicated.

Suppose, however, that the same contractual arrangement exists but that the parties agreed that the owner would pay each sub directly. The prime then, if the tax treatment urged by the taxpayer was adopted[3], could say that it did not receive the $1,000,000 subcontractor increments so should not be B&O taxed on them. Similar arrangements could be made vis-a-vis the sale of goods which, under usual circumstances, might go from manufacturer to wholesaler to retailer to consumer. The parties might concoct some arrangement whereby the consumer paid the manufacturer directly so that the two "middlemen" avoid receipt of and taxation on a portion of the total purchase price.

If such circumvention of the pyramidical B&O tax structure were permitted, its efficiency in generating revenue for state government would be substantially undermined. While these examples may seem extreme, they are the logical consequence of not taxing the gross amount due the taxpayer in this instance.

But, to reiterate, the reason we are denying the taxpayer's refund request is our finding that the taxpayer is legally entitled to receive the advisor's fee even though it does not actually do so. The taxpayer should continue its practices of recording it as income and treating it as a business expense for federal tax purposes which it is for state purposes as well.

DECISION AND DISPOSITION:

The taxpayer's petition is denied.

DATED this 23rd day of February 1990.

[3] Actually, in the present situation, it is our impression that the taxpayer *subcontracted* the task of investment advice to the party who took its fee directly out of the trust account.