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BEFORE THE INTERPRETATION AND 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. 90-267
[Taxpayer A]	)	Registration No. . . .
	)	. . ./Audit No. . . .
and	)	
[Taxpayer B]	)	Registration No. . . .
	)	. . ./Audit No. . . .

[1] **RULE 109:** B&O TAX - INTEREST - IMPUTED - ECONOMIC SUBSTANCE - BURDEN OF PROOF. When a taxpayer records in its books interest required to be imputed by federal tax law, this interest is taxable by the Department (absent an otherwise valid exclusion or deduction) unless the bookkeeping entry has no financial substance - i.e., if it does not reflect a true economic liability/asset. The burden of proof in this regard is on the taxpayer.

[2] **RULE 109:** B&O TAX - INTEREST - DEDUCTION - "INVESTMENT" V. CUSTOMER CREDIT. When a taxpayer extends credit to an affiliate which buys its product, resulting in the payment of interest, the taxpayer is not making an "investment" eligible for the RCW 82.04.4281 deduction.

[3] **RULE 109:** B&O TAX - INTEREST - DEDUCTION - "INCIDENTAL INVESTMENT OF SURPLUS FUNDS" - SALE OF INVENTORY WITH EXTENDED TIME FOR PAYMENT. A sale of inventory to an affiliate with an extended time for payment is not an "incidental investment of surplus funds." Sellen cited.

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: December 18, 1986

NATURE OF ACTION:

Petition concerning the taxability of sales to an affiliated corporation, which the taxpayer contends is now inactive and treated as a division.

FACTS:

Bauer, A.L.J. -- Taxpayer A's business records were examined for the period . . . through . . . . The resulting assessment was issued on . . . in the total amount of $ . . . .

Taxpayer B's business records were examined for the period . . . through . . . . The resulting assessment was issued on . . . in the total amount of $ . . . .

Taxpayer A and Taxpayer B (hereafter, A and B respectively) are controlled by the same stockholders that also own and control a third company, C. The three companies (all separate corporations) each handle different phases of the building materials business, and were all audited simultaneously.

A owns the land from which sand and gravel is extracted.

B uses sand and gravel in the manufacture of concrete blocks.

C uses sand and gravel and cement to manufacture and distribute concrete to building contractors and other consumers.

In recent years, A and B have been profitable, but because of extreme price competition in the ready-mix concrete business, C has been operating at a loss, and the other two companies have been required to "advance" funds to C in order to keep it in business.

The auditor found that substantial intercompany receivables were built up in A and B's books, which were based on A and B's sales of products to C. At the end of each year, A and B transferred C's receivables balances to "notes receivable," and interest charges were imputed for financial accounting and federal income tax purposes. A and B's intercompany receivables from C grew throughout the audit period.

A summary of the percentages of intercompany interest income to total income for A and B for their fiscal years ending September 30, 1982 through September 30, 1985 is as follows:

		Total Income	Intercompany Interest Income	Percent Interest to Total
Taxpayer A:				
F.Y.E.	9/30/82	1,217,395	17,151	1.4%
	9/30/83	1,093,092	47,998	4.4%
	9/30/84	1,433,415	83,635	5.8%
	9/30/85	1,447,031	105,131	7.3%
Taxpayer B:				
F.Y.E.	9/30/82	1,217,810	64,947	5.3%
	9/30/83	1,122,726	68,947	6.1%
	9/30/84	1,743,188	74,684	4.3%
	9/30/85	1,359,115	74,387	5.5%

The auditor assessed the interest recorded for financial and federal tax purposes, characterizing this interest as "interest or similar charges from extension of credit to customers."

TAXPAYER'S EXCEPTIONS:

A and B argue that the assessments on interest earned on loans to C be deleted based on RCW 82.04.4281 (previously RCW 82.04.430(1)) and Sellen v. Department of Revenue, 87 Wn.2d 878, 558 P.2d 1342 (1976). Specifically, the taxpayers contend that the interest charges on advances to C met the two conditions for that deduction because:

(1) they were amounts derived from investment, and

(2) the business activity did not constitute financial business. The loans were made only to keep a related company operating until the economic situation improved.

The taxpayer further explained that, for administrative convenience, there is only one master "accounts receivable" ledger for all three companies. It is kept in C's books. A and B thus do not have "accounts receivable" ledgers. All billings are thus in C's name.

For internal billing purposes, when C puts a receivable on its books, it credits either A or B. C then collects accounts receivable from customers, and transfers money to A and B periodically as money is needed.

For the audit years, due to severe price competition, C suffered operating losses and wasn't able to pay A and B what was due on their books. Amounts owed built up over several years. Intercompany interest charges were entered in the companies' books only because the IRS requires imputed interest charges.

The taxpayers characterize these transactions as A and B using their funds to support C. They claim the imputed interest charges represent financial income which is exempt under RCW 82.04.4281 and Sellen.

ISSUES:

In this case, the following inquiries are necessary to determine whether the taxpayer is eligible for the RCW 82.04.4281 deduction:

1. Is intercompany interest - recorded in a taxpayer's books because the Internal Revenue Service required a certain amount of interest be imputed - taxable under the B&O tax?

2. Was the taxpayer extending credit to A and B in their capacity as customers (does not qualify for RCW 82.04.4281 deduction)?

3. Was the taxpayer making an incidental investment of surplus funds (qualifies for RCW 82.04.4281 deduction)?

DISCUSSION:

Imputed interest.

A certain minimum amount of interest is required to be imputed by federal tax law when, otherwise, an interest-free loan would result. Federal tax must be paid on this imputed interest. The taxpayer's books in this case were adjusted to reflect the minimum amount of imputed interest required.

In Weyerhaeuser v. Department of Revenue, 106 Wn.2d 557, 723 P.2d 1141 (1986), the taxpayer's sales contracts did not specifically provide for interest. No interest was separately contracted for with the corporations' timber buyers, and no interest was separately "received." Weyerhaeuser's own interest computations were merely an internal bookkeeping device. The Court held that, because WAC 458-20-109 applied only to "[p]ersons who receive.... interest," that section could not be construed to apply to imputed interest.

The Court's holding was based on the economic realities of Weyerhaeuser's situation - no interest had either been contracted for or was due the taxpayer. The Court prohibited the Department from taxing bookkeeping entries which had no economic value.
We think, however, that when interest entered in a taxpayer's books does have economic value - even if it is claimed to have been originally imputed for federal tax purposes - the tax should apply. If the interest at issue is actually owed by the debtor, or paid to the taxpayer, it has economic substance and should be subject to tax.

[1] Thus, when a taxpayer records in its books interest required to be imputed by federal tax law, this interest is taxable by the Department (absent an otherwise valid exclusion or deduction) unless the bookkeeping entry has no financial substance - i.e., if it does not reflect a true economic benefit or legal right to receive interest. The burden of proof in this regard is on the taxpayer.

In this case, the taxpayer's representative has verified - before issuance of this determination - that the interest at issue has actually been paid to and received by the taxpayers in full. Thus, unless otherwise exempt or deductible, these interest bookkeeping entries were fully subject to tax.

Customer Credit.

RCW 82.04.4281 provides in pertinent part as follows:

> 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....

Excise Tax Bulletin 505.04.109 (ETB 505) further provides:

> However, no [RCW 82.04.4281] deduction is permitted with respect to:
>
> 1) interest or similar charges from extension of credit to customers; . . .

[2] Thus, when a taxpayer extends credit to an affiliate which buys its product, resulting in the payment of interest, the taxpayer is not making an "investment" eligible for the RCW 82.04.4281 deduction.

In this case, A and B sold their products to C, and extended the time for payment. The resulting interest was in the nature of customer financing, and is not properly deductible.

Incidental Investment of Surplus Funds.

[3] For purposes of RCW 82.04.4281, 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. Sellen, supra, at 883. A sale of inventory to an affiliate with an extended time for payment is not an "incidental investment of surplus funds."

A and B did were not making "incidental investment[s] of surplus funds." Instead, they merely transferred inventory to C and

forbore collecting immediate payment. Federally imposed imputed interest resulted. Such a circumstance does not qualify as an "incidental investment of surplus or excess funds."

Accordingly, we conclude that the interest entries here at issue in the taxpayer's books were not exempt from tax.

DECISION AND DISPOSITION:

The taxpayer's petition is denied.

DATED this 28th day of June, 1990.