

Cite as Det. No. 15-0187, 35 WTD 487 (2016)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Refund of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
))	No. 15-0187
))	
...)	Registration No. ...
))	

RCW 82.04.293: INVESTMENT MANAGEMENT SERVICES – Although the broker-dealer entity of a financial services business may incidentally engage in investment management services by researching or consulting, in the performance of its broker-dealer activities, these incidences of investment management services – for which, the broker-dealer receives no separate compensation – do not rise to the level of the broker-dealer’s primary activity. The distinction between the business activities of a broker-dealer and investment adviser is well-established by the regulatory framework applicable to financial service business. RCW 21.20.005(8)(c) (defines “investment advisor”), 15 U.S.C. s80b-2(a)(11)(C) (defines “investment adviser”).

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.

Anderson, A.L.J. – A securities broker-dealer entity appeals the denial of a refund request and contends that it is entitled to the lower business and occupation (“B&O”) tax rate provided for “international investment management services” under RCW 82.04.290. We conclude a broker-dealer does not provide investment management services and, therefore, does not qualify for the rate. Petition denied.¹

ISSUE

Whether a securities broker-dealer has shown that it was primarily in the business of providing investment management services for purposes of qualifying for the international investment management rate under RCW 82.04.290.

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

FINDINGS OF FACT

[Taxpayer] was the licensed securities broker-dealer affiliate of registered investment advisor [Advisor].² Taxpayer and [Advisor] were entities with similar ownership that were part of a financial services business that offered clients investment services, such as investment consulting, portfolio management, investment transactions, and related services. The two entities – Taxpayer and [Advisor] – operated through registered representatives – broker-dealers^[3] and investment advisors, respectively – at shared branches located throughout the United States.

Both the United States Securities Exchange Commission (“SEC”) and Washington State Department of Financial Institutions register and regulate broker-dealers and investment advisers. 15 U.S.C. §78o, §80b-1 *et seq.*; RCW 21.20.040(1), (3).⁴ Broker-dealers trade securities, for customers or on their own behalf, on registered national securities exchanges, i.e., NYSE, NASDAQ, etc.⁵ 15 U.S.C. §78c. Investment advisers furnish advice about the desirability of investing in purchasing or selling securities or other property, and are empowered to determine what securities or other property shall be purchased or sold. 15 U.S.C. §80a-2(20).

Clients paid Taxpayer a fee on each transaction for Taxpayer’s purchase and/or sale of securities. Approximately 2/3 of Taxpayer’s broker-dealer representatives were also registered investment advisers with [Advisor]. When serving a client of both entities, the representative would not segregate the client relationship by activity and entity. However, legally, Taxpayer performed the broker-dealer activities and [Advisor] furnished the investment advice – two separate, but affiliated, legal entities. In the case of a client being served by Taxpayer and [Advisor], Taxpayer was paid fees on each securities transaction and [Advisor] was paid periodic fees based on a percentage of assets under management.

On December 31, 2011, Taxpayer filed a refund claim with the Department of Revenue for \$. . . in business and occupation (“B&O”) tax, plus interest, paid from December 1, 2006 through December 31, 2012 (the “Refund Period”).⁶ Taxpayer claimed that it had overpaid B&O tax at

² Taxpayer ceased operations as of March 5, 2012; effective June 25, 2012, it is no longer registered with FINRA (Financial Industry Regulatory Authority) or the United States Securities and Exchange Commission (“SEC”). FINRA is “an independent, not-for-profit organization authorized by Congress to protect America’s investors by making sure the securities industry operates fairly and honestly.” <http://www.finra.org/about> (June 19, 2015). The SEC registers securities broker-dealers and registered investment advisors.

³ [WAC 458-20-162 is the Department’s rule explaining how broker-dealers are to be taxed. It reads: “With respect to stockbrokers and security houses, ‘gross income of the business’ means the total of gross income from interest, gross income from commissions, gross income from trading and gross income from all other sources” WAC 458-20-162.]

⁴ The SEC regulates broker-dealers under the Securities Exchange Act of 1934 and investment advisers under the Investment Advisers Act of 1940.

⁵ “The term ‘broker’ means any person engaged in the business of effecting transactions in securities for the account of others.” 15 U.S.C. §78c(4)(A). “The term ‘dealer’ means any person engaged in the business of buying and selling securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person’s own account through a broker or otherwise.” 15 U.S.C. §78c(5)(A).

⁶ Taxpayer originally requested a refund on December 31, 2011, for the period of December 1, 2006 through November 30, 2011, and the period was later extended to December 31, 2012.

the service and other activities rate and insurance brokerage rate because it qualified for the lower international investment management services rate and, further, it included excludable clearing house charges (amounts paid to other security houses for executing security transactions) in gross income.

The Department's Audit Division ("Audit") reviewed Taxpayer's refund request and issued a partial refund. Audit determined that Taxpayer did not qualify for the international investment management service tax rate because Taxpayer was primarily engaged in broker-dealer type transactions, and these activities did not meet the definition of investment management services because they lacked a management component. However, Audit did find that Taxpayer had over-apportioned income to Washington and had not deducted excludable clearing house charges. As a result, Audit issued Taxpayer refunds of service and other activities B&O tax in the amounts of \$. . . (for December 1, 2006 through December 31, 2010) and \$. . . (for January 1, 2011 through December 31, 2012).

Taxpayer appeals Audit's partial denial of a refund (\$. . . plus interest).

Taxpayer asserts that it was primarily engaged in investment research, investment consulting, portfolio management, investment transactions, and other related investment services, and provided significantly more than incidental investment advice to customers. Taxpayer asserts that its activities meet the definition of "investment management services" in RCW 82.04.293(2). In support of its assertions that its representatives provided more than incidental investment advice, it states that its representatives were required by the FINRA "suitability" rule to understand their client's financial profile, investment objectives, and risk tolerances before making any recommendations, and would meet with the client several times before trading any securities for the client. In addition, Taxpayer asserts that a majority of the time its representatives applied a higher professional standard than required of broker-dealers because, 2/3 of its representatives were dually licensed as investment advisers, and FINRA requires a representative to apply the highest applicable professional standard to all services performed.

However, should we determine that these activities do not qualify as "investment management services," Taxpayer disputes that the definition at RCW 82.04.293 requires "management component" to such activities. And, to the extent there is a management component, Taxpayer asserts that such a requirement should not apply until February 28, 2014, the date the Department issued ETA 3183.2014 – which states that a management component must be present in order to be providing investment management services.

ANALYSIS

Washington imposes a B&O tax "for the act or privilege of engaging in business" in the State of Washington. RCW 82.04.220. Different B&O tax rates apply, depending on the activity. Taxpayer seeks a preferential B&O tax rate under RCW 82.04.290, which provides in subsection (1):

Upon every person engaging within this state in the business of providing international investment management services, as to such persons, the amount of

tax with respect to such business shall be equal to the gross income or gross proceeds of sales of the business multiplied by a rate of 0.275 percent.

If we find that Taxpayer was engaged in the business of providing international investment management services, it would be due a refund equal to the difference between the service and other activities B&O tax rate (1.5%) and insurance brokerage tax rate (0.484%) and the international investment management service tax rate (0.275%), multiplied by Taxpayer's gross income during the period at issue. RCW 82.04.290.

RCW 82.04.293 explains when a person is engaged in the business of providing international investment management services and sets forth the following two-part test:

- (a) Such person is engaged primarily in the business of providing investment management services; and
- (b) At least ten percent of the gross income of such person is derived from providing investment management services to any of the following:
 - (i) Persons or collective investment funds residing outside the United States; or
 - (ii) Persons or collective investment funds with at least ten percent of their investments located outside the United States.

RCW 82.04.293(1). *See* Det. No. 14-0178, 33 WTD 600 (2014); Det. No. 11-0347, 33 WTD 195 (2014). The statute goes on to provide:

“Investment management services” means investment research, investment consulting, portfolio management, fund administration, fund distribution, investment transactions, or related investment services.

RCW 82.04.293(2).

The fundamental objective in statutory interpretation is to ascertain and carry out the legislature's intent, and if the statute's meaning is plain on its face, then the court must give effect to that plain meaning as an expression of legislative intent. *State v. J.M.*, 144 Wn.2d 472, 480, 28 P.3d 720 (2001). Plain meaning is discerned from all that the legislature has said in the statute and related statutes which disclose legislative intent about the provision in question. *Dep't of Ecology v. Campbell & Gwinn L.L.C.*, 146 Wn.2d 1, 11, 43 P.3d 4 (2002). We also must construe the statute so as “to avoid strained or absurd consequences.” *Deaconess Medical Center v. Department of Rev.*, 58 Wn. App. 783, 788, 795 P.2d 146 (1990). “To this end, the statute must be read as a whole; intent is not to be determined by a single sentence.” *Human Rights Comm'n v. Cheney Sch. Dist. No. 30*, 97 Wn.2d 118, 121, 641 P.2d 163 (1982).

Taxpayer was the broker-dealer entity of a financial services business where a separate, affiliated entity provided customers with investment advice. In order to be eligible for the international investment management services tax rate, Taxpayer must have been primarily engaged in providing investment management services. Taxpayer contends that its business activities fall within the definition of investment management services because it would conduct investment

research, investment consulting, portfolio management, investment transactions, and other related investment services in the course of trading securities; it further contends that any one of these activities is sufficient to meet the definition of investment management services.

In considering the definition of investment management services, we start by noting that activities included within the definition are highly regulated by both state and federal governments. In general, references to technical terms should be given the meaning commonly used in the regulated industry, absent clear legislative intent to the contrary. *See City of Spokane, ex rel. Wastewater Mgmt. Dep't v. Dep't of Rev.*, 145 Wn.2d 445, 452, 38 P.3d 1010 (2002); 2A *Norman J. Singer, Statutes and Statutory Construction* §47.31, at 366-67 (6th ed. 2000). Technical words or terms of art relating to trade, when used in the statute dealing with the subject matter of such trade, are to be taken in their technical sense. *Sutherland, Statutory Construction*, 5th Ed., vol. 2A, p. 260, §47.29.

Although a broker-dealer transaction may, for example, incidentally involve investment research or investment consulting, such transactions are not considered investment research or investment consulting. Taxpayer's activities as a broker-dealer and those of an investment advisor are subject to different regulatory frameworks. *See supra*. Broker-dealer transactions are not subject to regulation under the Investment Company Act of 1940. *See* 15 U.S.C. §80a-3(c)(2). *See also* RCW 21.20.005(8)(c), which provides that the term "investment advisor," does not include "a broker-dealer or its salesperson whose performance of these services [investment advice] is solely incidental to the conduct of its business as a broker-dealer and who receives no special compensation for them." Similarly, the definition of "investment adviser" in 15 U.S.C. §80b-2(a)(11)(C) explicitly excludes "(c) any broker or dealer whose performance of (advisory) services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefore."

Thus, the distinction between providing investment management, investment advisory, and investment transaction services, as opposed to broker-dealer services, is one that is established by the regulatory framework governing investment services. We disagree with Taxpayer's approach of taking each specific activity listed and construing that activity as broadly as possible. Under the approach advocated by Taxpayer, any investment service could be characterized as an investment management service. This approach of broadly construing individual terms to broaden a statutory definition was rejected by the court in *Port of Seattle v. Department of Rev.*, 101 Wn. App. 106 (2000), *review denied*, 142 Wn.2d 1012, 16 P.3d 1264 (2000). Accordingly, we find that Taxpayer's activities as a broker-dealer do not meet the definition of investment management services.

Further, we note that our interpretation is consistent with ETA 3183.2014, which provides the following guidance in interpreting which activities constitute "Investment Management Services":

When is a person engaged in the business of providing investment management services?

...

Because the activity being taxed is “investment management services,” the Department interprets this definition to require some management component in each of the enumerated services.

- For example, a broker-dealer transaction may incidentally involve investment research or investment consulting, but such transactions are not considered “investment management services” because they lack the requisite management component.

Taxpayer seeks to distinguish itself from other broker-dealers because its representatives allegedly provided more than incidental investment advice. In support of this assertion, Taxpayer cites to the FINRA Suitability Rule for broker-dealers and the fact that a majority (2/3) of its representatives were dually licensed as broker-dealers and investment advisers (as well as, dually employed by Taxpayer and [Advisor]) and applied a [higher] fiduciary standard when trading securities for clients.

As relevant here, FINRA Rule 2111 prescribes a “suitability” professional standard for broker-dealer activities; a broker-dealer is to “. . . have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, . . .” FINRA Rule 2111. However, the Suitability Rule does not change the underlying activities of Taxpayer’s broker-dealer representatives – broker-dealer representatives are being paid a fee to trade securities for a client. The requirement that broker-dealers have a reasonable basis to believe that a securities trade is suitable for a client falls very short of providing investment management services for a client.

With respect to dual representatives, Taxpayer appears to be asking us to disregard its corporate form in order to conclude that its broker-dealer representatives were engaged in investment management services. Although affiliated, [Advisor] provided clients with investment advice – not Taxpayer – and while many representatives worked for both entities, they did so in order to engage in both investment advising and trading securities because [Advisor] and Taxpayer were only licensed to perform one such activity, respectively. Washington courts and the Department generally will respect a taxpayer’s use of the corporate form. *See* Det. No. 05-0200, 25 WTD 12 (2006). A corporation is considered a separate entity which must be respected unless it is used to intentionally violate or evade a duty. *Dickens v. Alliance Analytical Labs, LLC*, 127 Wn. App. 433, 440, 111 P.3d 889, 892 (2005). There is no evidence in this case that Taxpayer’s or [Advisor’s] corporate forms were used to violate or evade a duty. The instances where dually licensed representatives traded securities does not change the fact that when making such trades, representatives were working for Taxpayer, and for the reasons explained above, not engaged in investment management services.

As to Taxpayer’s request for the delayed implementation of ETA 3183.2013, we note that the Department publishes excise tax advisories in order to provide guidance on the application of a statute or rule. An excise tax advisory does not change the statute or rule and RCW 82.04.293 has been effective since July 1, 1995. Accordingly, we see no reason for delaying the application of RCW 82.04.293.

DECISION AND DISPOSITION

Petition denied.

Dated this 16th day of July, 2015.